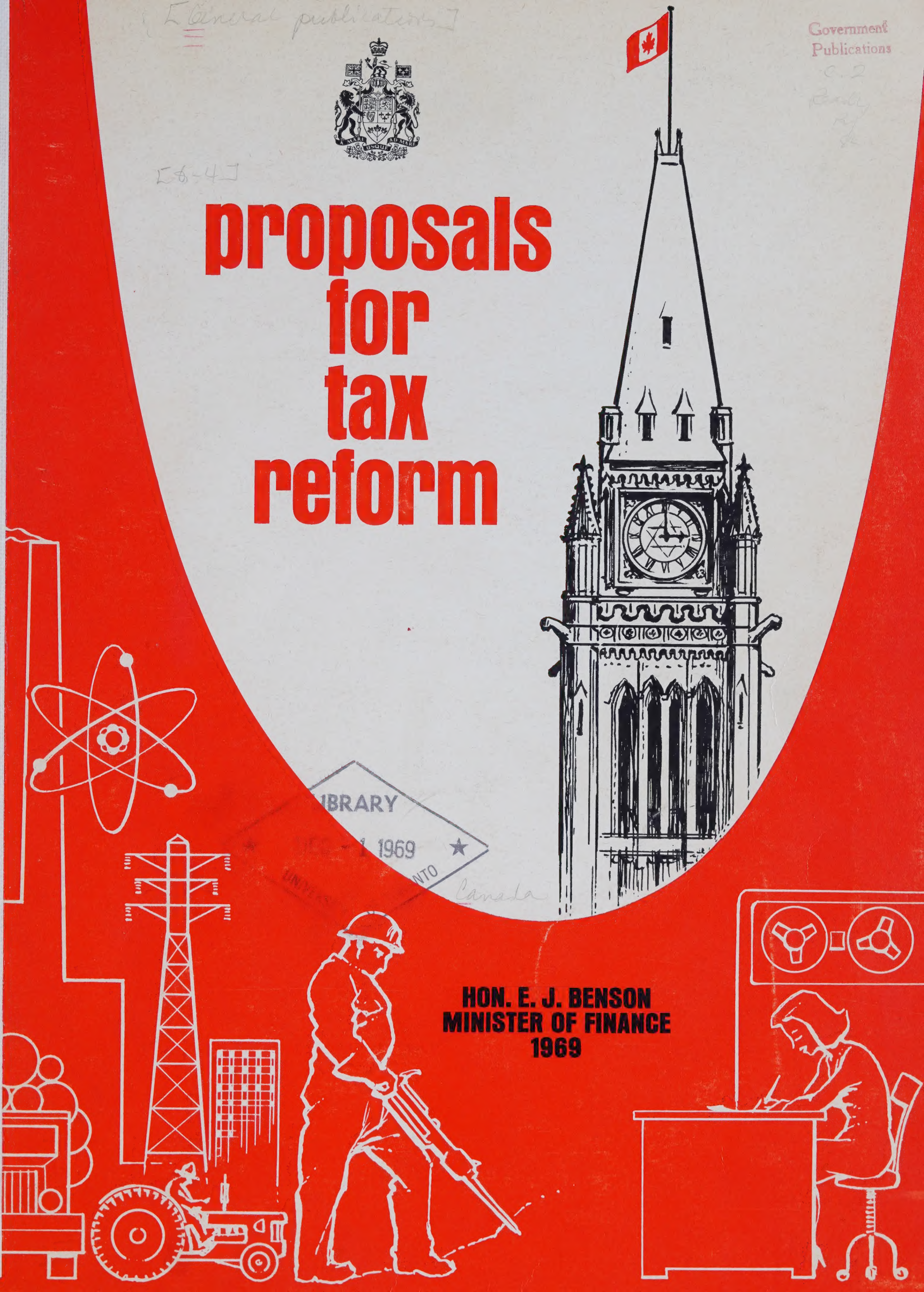
Canada. Dept. of Finance

Proposals for tax reform.



proposals for tax reform

HON. E. J. BENSON
MINISTER OF FINANCE
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Setting and Summary

1.1 In this White Paper the Government of Canada places before Parliament, the Canadian people and the provincial governments its major proposals for reform of the income tax structure. The government will welcome public discussion of the proposals, particularly in the parliamentary committee considering them. Detailed discussions are also planned with provincial government representatives.

1.2 For most of this decade the strengths and weaknesses of the income tax system have been studied closely and debated vigorously. Widespread recognition of defects in the system led in 1962 to the appointment of the Royal Commission on Taxation, with the late Mr. Kenneth Carter as chairman. In its monumental report published early in 1967 the commission made serious criticisms of the existing law and proposed some fundamental changes. A vigorous public debate arose over the commission's report and the government received many letters and briefs concerning it. The government itself has not yet taken part in this debate but it has studied the report and the comments upon it, assessing both the facts of the situation and the attitudes of Canadians toward the present tax structure and various proposals for its improvement.

1.3 The need for a general reform is clear, and in some instances striking. The problems to be faced admit no easy solutions. Reforms in this complicated and controversial area of government policy will inevitably be open to argument. The needs of the federal and provincial governments for money to do useful and important things are so great that we cannot now afford to reduce the over-all revenues from personal and corporate income tax.

1.4 The government's proposals are the result of careful study of tax principles, practices and impact. The government believes they are the best practical proposals to attain our objectives in present circumstances. They are advanced for discussion and review in the light of that discussion before Parliament is asked to approve a bill to implement tax reform. The government believes that taxpayers and those who represent them in Parliament and in provincial legislatures should contribute actively at an early stage to the formulation of policies that so directly and vitally affect them.

1.5 Let us look at the main points to be met:

- **Canadians in the lower income tax brackets face a heavy total tax burden. In recent years sales taxes and property taxes have been increased substantially. Where changes in the income tax can provide relief, it must be given to those with lower incomes. The government proposes increases in the exemptions to ease the burden on these individuals and families.**
- **Important forms of income and benefits escape taxation. The government proposes to bring them into taxable income. In particular, a tax on capital gains is proposed.**
- **Tax can be avoided under the present law by clever devices. The reform must close loopholes now available to those with the wealth and expert advice to use them.**
- **Wage earners are unable to deduct many legitimate expenses from taxable income. New deductions would be introduced to benefit employees and working mothers.**
- **Corporations are taxed in ways that are open to abuse and that fail to recognize their differing relationships with shareholders. The government proposes changes under a new system that would be fairer to small shareholders and that would stimulate Canadian ownership of Canadian business.**
- **The mineral industries enjoy special tax benefits that have existed for many years but that are unnecessarily costly and inefficient. Assistance to mineral exploration and development must do its intended job in a more direct way that is less costly in terms of revenue.**

The Aims of Tax Reform

1.6 A number of goals and standards have guided the government in its approach to reform. They include a fair distribution of the tax burden based upon ability to pay; steady economic growth and continuing prosperity; the recognition of modern social needs; widespread understanding of and voluntary compliance with tax laws, combined with enough detail to block loopholes; and, finally, a system that can and will be used by the provinces as well as Canada.

1.7 In raising the large revenues required to meet the needs of modern government, we must be certain that the total tax burden is distributed fairly. All levels of government together now require more than one-third of the gross national product in taxes, social security contributions and other revenue to provide public services. The federal government is holding its own operating expenditures under control but its total needs are growing to meet such priorities as old age pensions, hospital and medical care, support of higher education, retraining our work force, equalization payments to the less wealthy provinces, and programs for industrial and other economic development.

1.8 Fairness in taxation implies two principles. First, it means that people in similar circumstances should carry similar shares of the tax load. But, for a variety of reasons—historical accident, outdated decisions or short-term expediency—taxpayers' circumstances are defined in ways that ignore certain forms of income and expenditures. Many of the wealthy in our society have benefited unduly. A taxpayer is understandably angry when he sees that he carries an extra tax burden to pay the cost of unfairly low taxes on others. This concept of fairness must shape the standards we apply in stating just what income is. The royal commission advanced the understanding of this subject greatly, although the government believes the commission carried some of its arguments to extremes which the Canadian public would not support. One of the government's decisions in this regard has already been implemented by Parliament in connection with the estate taxes.

1.9 Fairness also requires that people with higher incomes, people who are better off, should be expected to pay in taxes a larger share of their incomes than persons with lower incomes. This concept of "ability to pay" is embodied mainly in the personal income tax as a progressive graduated

tax having increasingly higher rates as income increases. There is no single or simple rule for increasing the tax rates up the income ladder that can be said to be the "right way". It is a matter of opinion, of judgment.

1.10 The second main objective of tax reform is to see that the tax system does not interfere seriously with economic growth and productivity. Taxes by their nature cannot always promote all our economic goals, but they should interfere as little as possible with incentives to work and invest and with the directions our economy follows in meeting demands of consumers and foreign markets. Some proposals in this paper are intended to ensure that the incentive to work and invest is not unduly inhibited and that investments needed for productivity and public purposes are not rejected in favour of less desirable alternatives just because of their tax consequences.

1.11 The government is aware of a continuing need to spur certain kinds of activities. Some economic ventures that involve exceptional risks also promise exceptional rewards—in employing Canadians, in pushing back frontiers, in spurring trade and technology, and in improving secondary industries. Much of the government help now given to such development is through expenditures and credits. Tax laws, however, have long been used to provide incentives to such ventures, and the government believes they should continue to be so used in a number of specific ways that are clearly understood and justified.

1.12 The present reform of the income tax should produce a reasonably stable system which can develop, but which need not be fundamentally revised for a considerable period. Future changes in rates may be needed to meet economic circumstances and requirements for expenditures. But repeated changes, particularly in the basic structure of the tax, would be likely to bring uncertainty and apprehension. Individuals and businesses must be able to plan their affairs sensibly, particularly in making investments that yield a return for many years. This need for stability also implies that reforms should not include retroactive changes, applying to incomes earned in previous years. The government's proposals provide that the changes in rules would apply only to periods after publication of the proposals. In particular, they will not bring into tax capital gains earned before a future date to be announced.

1.13 In seeking equity and our economic objectives we must recognize the social realities of modern Canada. Our taxpayers live with, benefit from, and pay for many social development programs which affect their needs and their incomes, their institutions and their attitudes. Our increasingly urban society imposes upon governments and other public authorities demands and conditions which strain to the limit their ability to finance and to execute their activities. The reformed income tax must further the proper development of this changing society.

1.14 Another very practical goal is to design our tax system so that taxpayers can and will comply with it voluntarily. The vast majority of taxpayers comply in all respects with the income tax laws; we must maintain their willingness to do so and protect their interest against others who may exploit loopholes in the law. This means the system must be simple enough for the taxpayer to understand but detailed enough to block opportunities for abuse. Our tax laws must be trusted, the burdens they impose must in the end enjoy public acceptance, and their administration must be seen to be efficient and impartial.

1.15 A final important goal for tax reform in Canada must be its appeal to provincial governments and legislatures as a system they too can use. In our federal structure of government we are striving for harmony in federal and provincial tax policies and practices. Much has been accomplished in this respect in the past generation. The proposals in this paper have been designed to permit that progress to continue.

Three Limits on Change

1.16 Inevitably the government faces serious limitations in working out its proposals for changing the income tax. These include the over-all need for revenue, the unfavorable features of other tax

sources, and the economic context.

1.17 The royal commission proposed some over-all reduction in the personal income tax on the basis of assumptions about revenue requirements that are no longer valid. Public expenditures —federal, provincial and municipal—have increased substantially since 1964, the year on which the commission based its estimates of required revenues. These additional expenditures are already providing tangible benefits to taxpayers and improving the economic and social environment in which taxpayers live. They include medicare, housing, youth allowances, student loans, university support, occupational retraining, improved assistance to those in need, and major expenditures on industrial and regional development.

1.18 Major sources of new revenues anticipated in the royal commission's proposals have already been tapped by Parliament to meet current requirements. Complex changes have been made to the Income Tax Act to tax the life insurance industry on a basis as similar as possible to other industries, and to tax savings accumulating in life insurance policies on a basis similar to other savings. The government has with Parliament's approval revised allowances for bad debts and investment losses by financial institutions, notably banks and mortgage lending institutions. A further speed-up of payment of corporation income taxes to place them on a current basis has been put into effect. The commission proposed that the transmission of property by bequest and by gifts should be taxed fully as income, which would have increased the weight of the taxes two and one-half times. The government and Parliament in revising the estate and gift taxes earlier this year took a different view. While gifts and bequests from husband to wife were exempted from tax, rates on amounts given or left at death to others were increased only to the extent necessary to maintain existing revenues from estate tax and to prevent tax avoidance.

1.19 Personal income taxes are the most important single source of government revenues, making up $7.8 billion of the $27.6 billion all governments expect to raise in revenues this year. Their central position in the revenue structure is appropriate. More than any other tax the personal income tax can be carefully adjusted to the income of the individual and the circumstances which affect his ability to pay, such as family responsibilities and unusual expenditures or expense obligations. To see that the whole tax system is fair, we must ensure that the income tax remains the main tax levied on Canadians. It should be given priority in the tax reform program. Reform of the sales tax is less urgent and can be undertaken after action on the proposals in this paper.

1.20 Other major tax sources in Canada should not be used in substitution for the income tax. General sales taxes are employed extensively by both federal and provincial governments and now yield approximately $4 billion. For most Canadians, they are equivalent to a combined retail rate ranging from about 13 per cent to over 16 per cent and apply to nearly all purchases except foods. They have been increased in recent years. Broadly speaking, the weight of such taxes is proportionate to expenditures and to incomes, and inferior in fairness to the graduated income tax. The third most important tax is the real property tax, levied chiefly by municipalities under provincial law. It creates revenues of about $2.9 billion per year and bears heavily on those with low incomes, if we take into account its effect on rents. Rates have been increased substantially in recent years. Finally, our corporation income taxes are already high by international standards; further increases would be damaging to our economic development and competitive ability, making it more attractive to locate industries in other countries.

1.21 The structure of Canadian income places important limits on any program of tax relief for those with average incomes. Statistics for 1967, the latest year available, show that more than half of those paying income tax had incomes of less than $5,000 per year—which was approximately the average industrial wage. In the middle range almost 2,500,000 of our 6,650,000 taxpayers that year earned between $5,000 and $10,000, accounted for 46 per cent of total income of all taxpayers, and paid 44 per cent of all income taxes. In sheer number, the impact of these middle-income taxpayers is enormous. We would help many of them through the proposed tax reforms but the relief cannot be dramatic and inevitably in aggregate much of the

cost must be borne by those at the upper end of the $5,000 to $10,000 scale.

1.22 Fewer than 500,000, or 7.5 per cent of taxpayers, had incomes over $10,000 and they paid more than 35 per cent of the total income tax. The wealthy alone could not possibly pay the cost of any substantial tax reduction for low-income Canadians. For example, if an additional tax of $1,000 was paid by every taxpayer with income over $25,000 the additional revenue in 1967 would have totalled $48 million—enough to reduce taxes by only $13 for each taxpayer with income under $5,000. A person with a taxable income of $25,000 a year already pays 50 cents or more in income taxes on every extra dollar of income he receives. The way to obtain more revenue above this level is to tax capital gains, close the loopholes, and encourage people to work and invest by avoiding excessive rates on incomes in the highest brackets.

THE PROGRAM IN BRIEF

1.23 The following proposals are commended to Canadians as practical and effective measures to accomplish the objectives of tax reform. They owe much to the report of the royal commission and to the public debate which followed publication of the report. They are planned to produce about the same initial revenue as existing laws and rates. Eventually revenues would grow because some transitional arrangements would expire and because increasing amounts of capital gains would be taxed.

1.24 The form of the personal income tax would be streamlined, greatly simplifying the individual's task in calculating his tax. The old age security tax and the social development tax would be merged into the graduated tax, and several other adjustments and surtaxes of recent years would be eliminated. The new graduated rates would determine the federal tax, and there would be no general abatement for provincial taxes. The provinces would be invited to apply their tax as a percentage of the federal tax, and on that basis the federal government would continue to collect this revenue for the provinces without cost to them. The Old Age Security Fund would be credited with the equivalent yield of the present old age security tax.

Higher Exemptions

1.25 To remove or reduce taxes on lower-income taxpayers the government proposes to increase the basic personal exemption for a single person to $1,400 from $1,000 and for a married couple to $2,800 from $2,000. The basic standard deduction available in lieu of deductions for charitable donations and medical expenses would remain at $100. Consequently those taxable as single persons with income under $1,500 would have no tax to pay and those taxable as married would have no tax to pay if their incomes were under $2,900. These new exemptions would be much higher than those in other countries as shown in Table 3 page 26.

1.26 This change in exemptions alone would take about 750,000 Canadians off the income tax rolls. Taken together with the other changes proposed, it would reduce taxes on almost 3,000,000 more at the low end of the taxable scale. The benefits which larger exemptions would otherwise give to those with higher incomes would be offset by higher rates of tax.

1.27 The new rates of tax would replace the present graduated rates, the provincial abatements, current surtaxes, the old age security tax and the social development tax. The rates would be revised to take into account the increase in exemptions, the taxation of capital gains, and the various other changes, while still bringing in the same amount of total federal revenue and serving as a base for the same total of provincial revenues. The schedule of rates is on page 25 and subsequent tables illustrate the effects on single and married persons. When the new employment expense allowance is taken into account (see below), the amounts of tax under the new rates would be less than the present tax on single persons up to an income of about $3,400 per year, and on married persons up to an income of about $9,100. For incomes above these levels the tax would be higher than under the current law, particularly when changes in the definition of income are taken into account.

Capital Gains as Income

1.28 The government has decided to include capital gains and a number of other benefits in income subject to tax. Reviews of this subject by the royal commission and the government led to the conclusion that this is essential in order to be fair between those receiving such gains and others deriving their incomes from other sources. Moreover, the taxation of gains is essential to block loopholes effectively. The economic effects of taxing gains have been appraised and are considered unlikely to interfere significantly with incentives to save and invest in Canada.

1.29 Those who make substantial capital gains in the stock market or in real estate increase their ability to spend money just as those who earn wages or derive an income from carrying on business. Interest payments are already fully taxed. Capital gains are now widely sought as an objective in investment. Indeed the freedom of capital gains from tax is distorting the investment of savings under present circumstances.

1.30 In general we propose to include capital gains fully in income for most classes of assets whenever they are realized by the sale of such assets, and to allow realized capital losses to be deducted from income. Certain exemptions would be permitted for taxpayers' homes and for articles of personal property. Special rules would apply to the marketable shares of widely-held Canadian companies. On such shares accrued gains would be taxed every five years and accrued losses allowed as deductions at such time. Only half the gain or loss on such shares would be taken into taxable income in recognition that the corporation income tax paid by such companies is only partially credited for personal income tax. This is explained in Chapter 3.

1.31 Once capital gains are included in taxable income, the portion of the total income of the wealthy that is brought to tax would be dramatically increased. The tax system would be significantly more progressive even without the ostentatiously high rates now in use. It is proposed that the marginal rates in excess of 50 per cent be reduced to the neighborhood of 50 per cent in four instalments as the capital gains subject to tax increase. As the estimates in Chapter 8 indicate, based on 1969 incomes by the fifth year of the new system the inclusion of capital gains in taxable income should add about $345 million to personal income taxes, while the reduction of the top rates to 50 per cent on other income should cost about $40 million.

New Deductions

1.32 The government has examined the deductions individuals may claim for various costs they incur, as well as differences in treatment between taxpayers who are employed and those who carry on a business or profession. The royal commission said many employees have been over-taxed because they have been denied the deduction of almost all expenses incurred in earning wages and salaries. But millions of taxpayers are involved, and a very wide range of expenses could be related to earning their employment income. These taxpayers do not keep detailed records. The government has found no practical way to permit employees to deduct actual costs as do those carrying on a profession or other business. We propose to provide employees with a general deduction to cover expenses, in addition to certain specified deductions. The amount would be 3 per cent of employment income, up to a total of $150 a year. This could benefit more than 6,500,000 persons, the great majority of them earning less than $10,000 a year.

1.33 Costs of looking after young children when both parents are working, or when there is only one parent and that parent is working, would be allowed as a deduction subject to certain conditions. This new plan is intended primarily to benefit mothers who need to work to support their families, and would be in addition to the normal exemption for children. The maximum expenses allowed would be the lower of $500 per child under age 14 or $2,000 per family.

Other Items in Income

1.34 By including more receipts in income the government proposes to make the definition of in-

come more comprehensive and to distribute the tax load more fairly. Some additional revenue would arise from this change, but it would be offset by additional deductions to be allowed from income.

1.35 Various fringe benefits received by employees or by the owners of businesses would be included in income for the first time. For example, an employee or owner of a business with a business-owned car available for his personal use would be required to include a minimum amount in his taxable income unless he pays the business at least that amount for the use of the car. There are other fringe benefits whose value cannot readily be measured in the hands of the recipient; for example, the use of hunting and fishing lodges, yachts and airplanes, the payment of social and recreational club dues, and the entertainment costs that are included in expense accounts. These costs would no longer be deductible to the employer.

1.36 The government has decided that it would make the tax system fairer if the treatment of unemployment insurance were changed to permit workers to deduct their contributions to the fund and to require them to pay tax on benefits received. Many of the benefits are received by employees with average or higher than average incomes who are unemployed for relatively short periods, and whose annual incomes equal or exceed the annual earnings of others. The higher their incomes the greater the tax benefit. It is fairer to tax them on this part of their income, as long as we permit all employees to deduct their contributions. Anyone on unemployment insurance benefits for most of the year is likely to pay little or no tax.

1.37 It is also proposed, in fairness to other taxpayers, that fellowships, research grants, scholarships and bursaries be treated as taxable income but subject to the deduction for tuition fees and costs incurred for research. Undergraduates would seldom need to pay tax because few scholarships and bursaries are larger than the new personal exemptions plus the fees that may be deducted from students' incomes. But if students have other income, there is no reason why they should not be taxed like other Canadians.

1.38 For many years, members of the armed services have been taxed under special regulations which are aimed at simplicity of administration but confer special benefits. The regulations are no longer necessary on administrative grounds and would be dropped. Members of the Canadian armed forces would then be taxed under the normal terms of the Income Tax Act.

A New System for Corporations

1.39 The government proposes to alter the method of taxing corporations by establishing a single rate of corporation tax and providing a system of credits to shareholders for corporate taxes paid. An important distinction would be made between private, closely-held corporations and public, widely-held corporations.

1.40 For closely-held corporations, which are usually smaller businesses managed by the shareholders, the tax should be related as closely as possible to rates paid by individual shareholders. There is usually a close identity between the shareholders and the corporation. These corporations usually compete in markets with unincorporated businesses subject only to personal income tax. Under the proposed plan the federal income tax paid by such corporations would be treated as a prepayment of the personal income tax on behalf of individual resident shareholders. Under certain conditions the corporation could elect to be taxed as a partnership of its shareholders. In other cases the shareholders would pay tax on a sum that includes their dividends plus a related amount of corporate tax already paid; and they would then claim credit for the corporate tax paid, and qualify for a refund if their own rates are lower than the corporate rate.

1.41 The government believes that this is a fairer way of taxing the income of Canadians which flows through corporations than the existing system with its lower rate of corporate tax on $35,000 of profits annually. It proposes to remove this lower rate gradually over a period of five years. Thereafter, the benefits of low rates of tax would go to shareholders with small incomes rather than to corporations with small incomes.

1.42 Widely-held corporations are usually larger businesses where the link between shareholders

and management is tenuous. Such corporations are themselves important economic entities. Their products or services are usually sold in competition with other large corporations, where prices yield an adequate return after paying corporate tax. One half the corporate income tax paid by such corporations would be regarded as a prepayment of individual tax for individual Canadian resident shareholders, but the other half would not be linked in this way. Shareholders receiving dividends from profits taxed under the new plan would be liable for tax on the dividend plus an amount of "creditable tax" equal to half the dividend and would be given credit for that amount of tax. This system would be roughly equivalent to the present dividend tax credit for taxpayers in the 50-per-cent tax bracket and would be more favorable for those in lower tax brackets. It would thus provide a powerful incentive for investment by Canadians in Canadian corporations.

1.43 Examples of this plan are set out in paragraphs *4.25* and *4.37*.

1.44 This new system would:

- offer a substantial inducement for Canadians to invest in Canadian business;
- when combined with the proposed method of taxing capital gains, make possible a fair and fully effective but economically tolerable tax system;
- prevent surplus stripping and most other tax avoidance devices;
- be fairer in its treatment of lower-income shareholders than the present dividend tax credit and preferred low rate of tax on the first $35,000 of corporate income.

International Aspects

1.45 The Income Tax Act sets out the basic international elements of Canada's income tax. Modifications are made by negotiated tax treaties with other countries. The present reform proposals will involve renegotiation of such treaties as well as revision of the act.

1.46 Relatively little change is proposed in the structure of taxes imposed on the Canadian income of people or corporations in other countries. However, to meet the problem presented by the diversion of income to "tax-haven" countries, the basic rate of withholding taxes set by the Income Tax Act on interest, dividends, rentals, and royalties paid or credited to non-residents would be increased to 25 per cent from 15 per cent. This increase would not override the rates in our existing treaties. Further, the 25-per-cent rate would generally be reduced in new treaties to the current levels, usually 15 per cent. Some new safeguards would be introduced to ensure that corporate income in Canada is not reduced artificially by making payments in the form of interest and royalties to non-resident shareholders or related companies, instead of paying dividends. Pensions paid from Canada to persons living outside would be subject to a withholding tax of 25 per cent, but with provision for lower or higher rates if the circumstances of the recipient warrant. This is proposed because it is planned to maintain tax exemptions for contributions to registered pension plans and the investment income of such plans in the expectation that payments out of the pension funds will be taxable income.

1.47 There would be some changes in the taxation of income earned by Canadian residents and corporations from sources outside Canada to prevent "tax havens" being used to evade Canadian taxes. Individuals would continue to pay Canadian taxes on investment and other income from sources outside Canada. They would receive a credit for the withholding tax or other income tax paid directly to governments of other countries. Corporations would also receive such credits except when income is from a controlled foreign corporation.

1.48 New distinctions between classes of foreign corporations controlled from Canada are outlined in Chapter 6 and will be further elaborated in supplementary papers. Unless tax treaties provide otherwise, Canadian corporations would be taxed on dividends received from foreign corporations in which they have a substantial interest. However, they would receive credit for the withholding taxes levied on the dividend by the foreign

country, and for the corporation tax paid by the foreign corporation on the profits from which the dividend was paid. Tax treaties would maintain the exemptions for dividends received from foreign corporations more than 25-per-cent-owned by the recipient Canadian corporation, and carrying on bona fide active business operations in the foreign country. Other provisions patterned generally on the United States law would impose full Canadian taxes on corporate income accruing in "tax-haven" operations. Various other detailed safeguards would be introduced to keep to a minimum the use of non-resident corporations to reduce Canadian taxes of Canadian residents.

The Mineral Industries

1.49 For many years special rules have been applied to determine the income from mining and from the production of oil and natural gas. These have been reviewed by the government in the light of the criticisms, proposals, briefs and discussions of the last several years.

1.50 The government has decided that some special rules should still apply in determining the income derived from the mineral industries, in order to encourage exploration for and development of mineral deposits. These inducements are intended to encourage the establishment and growth of highly productive industry in areas of Canada outside those where rapid urban and industrial growth are already occurring. However, the special rules should be revised substantially to ensure that really profitable projects pay a fair share of the national revenues, as other industries do, and that the inducements offered are efficient.

1.51 Two main changes are proposed. The first would replace the three-year tax exemption for new mines with a special rule permitting capital costs of fixed assets purchased for the development and operation of a new mine to be charged off against income from that mine as quickly as desired. This change would take effect in 1974 at the expiration of the period for which the government in 1967 gave assurances that the three-year exemption would continue. The new rule would ensure that in the high-risk business of mining, taxes would not be paid until investments in new projects are recovered, but it would do so on a more economical basis than the present exemption.

1.52 The second change concerns depletion allowances. The existing maximums would continue to apply—generally no more than one-third of production profits—but a taxpayer could run out of depletion allowances unless he continues to explore for, and/or develop, Canadian minerals. Every $3 of qualifying expenditures made after this White Paper is published would "earn" the taxpayer the right to $1 of depletion allowances if and when his production profits permit. Depletion allowances on new properties would have to be "earned depletion" immediately: "unearned" allowances would be continued for five years on existing properties as a transitional measure. This proposal is more fully explained in Chapter 5. That chapter also sets out other changes of detail applying to the mineral industry. They flow mainly from other more general changes proposed in the tax system.

* * *

1.53 The following chapters of this paper describe these proposals in more detail. They commence with the general provisions relating to individual Canadians and go on to deal more specifically with capital gains, corporations and shareholders, business income, the international aspects of taxation and the federal-provincial aspects. The final chapter discusses the effects of the changes on government revenue and on the Canadian economy.

2

The Individual and Family in Tax Reform

2.1 The government's two most substantial proposals are to increase personal tax exemptions and to bring capital gains into taxable income. These key proposals would make the income tax more progressive by measuring income more realistically and by taking less tax from those less able to pay. Tax relief would thus be granted where it is most needed. The inequity of allowing substantial tax-free gains to many well-to-do persons would be ended. A number of other important changes affecting individuals are also proposed.

Personal Exemptions

2.2 Since 1949, personal tax exemptions have stood at $1,000 for single taxpayers and $2,000 for married taxpayers. About 60 per cent of taxpayers pay on the single exemption basis partly because many husbands and wives both have taxable incomes. Since 1957, an optional standard deduction has in effect added $100 for taxpayers not claiming a deduction for medical expenses and charitable gifts.

2.3 Although basic exemptions have not changed for 20 years, circumstances in Canada have. New and enlarged government programs in the welfare field have made it necessary to raise substantially more revenue. Because the graduated personal income tax is one of the fairest ways to raise revenue there has been increased use of this tax. Despite this need for more income tax revenue the basic exemptions have not been lowered and they continue to exceed those of other comparable countries as Table 3 indicates. However, they are now much lower than formerly in relation to the general level of earnings in Canada. Moreover, provincial and federal sales taxes and municipal property taxes have increased substantially, falling heavily on incomes just above exemption levels. And the present exemptions will no longer compare as favorably with those in the United States if proposals now before Congress are approved.

2.4 These factors led the government to propose an increase in personal exemptions to $1,400 from $1,000 for single taxpayers (or married taxpayers filing as single) and to $2,800 from $2,000 for married taxpayers filing as such. The deductions for children and other dependants would remain the same, although some of the conditions relating to them would be changed as noted below. These new exemptions plus the $100 standard deduction, which would be continued, would mean that those entitled to the married exemption would be exempt up to an income of $2,900 and single persons to $1,500. These increases would free from income tax about 750,000 persons now subject to tax.

Family Unit

2.5 The royal commission proposed that the family, including dependent children at home,

should be taxed as a unit, using a separate schedule of rates from that applicable to individuals. The government considered this proposal carefully, as there is logic in the argument that the family, or at least the husband and wife together, is the basic spending unit. A number of other countries either permit or require the incomes of husband and wife to be added together for tax purposes. However, the commission's proposed family unit tax would have imposed a "tax on marriage"—that is, a husband and wife each having an income would together pay more tax than two people with the same incomes who were not married. This we felt to be unfair and undesirable at least for small and medium incomes. Even then, however, a wife who goes to work would have her income added to her husband's income and in effect taxed at the rates that would apply if his income were increased by the amount of her income. We are not prepared to undertake at this time such a change to a new system with a separate rate schedule. After the basic reforms proposed in the present paper are in effect it would be possible to reconsider separately a family unit basis, or a more complicated system similar to some of those used in other countries, as a further instalment of reform.

Deductions for Dependants

2.6 The government has reviewed the deductions allowed from taxable income for children and other dependants—currently \$300 per year for children under 16 and \$550 per year for others. We believe any action on these should be related to the further evolution of Canada's social security and social development programs. These programs are now under review. In the meantime, it is proposed that deductions under the Income Tax Act for children and other dependants remain as at present, and family allowance payments remain exempt.

Child Care Expenses

2.7 We propose to permit deduction of the child care expenses that face many working parents today. The problem of adequately caring for children when both parents are working, or when there is only one parent in the family and she or he is working, is both a personal and a social one. We consider it desirable on social as well as economic grounds to permit a tax deduction for child care expenses, under carefully controlled terms, in addition to the general deduction for children.

2.8 Costs to be deducted would include babysitting expenses, day nursery care and, up to \$15 a week, lodging paid at boarding schools and camps. Amounts would be deductible up to \$500 per child under the age of 14, or \$2,000 per family. The total allowed would also be no more than two-thirds of the earned income of the parent with the lower earned income; it would be necessary to ensure that in fact there is not a parent at home. Deductions would have to be supported by receipts and could not be claimed for payments for care of a child by a person claimed by a taxpayer or the taxpayer's spouse as a dependent relative.

2.9 This new deduction for child care costs would be a major reform. While it is not possible to make an accurate forecast of the number who would benefit from this new deduction, it seems likely to be several hundred thousand families. It would assist many mothers who work or want to work to provide or supplement the family income, but are discouraged by the cost of having their children cared for. For families in these circumstances child care expenditures constitute a real cost of earning income.

Employment Expenses

2.10 The tax law permits those in business and the professions, in determining their income for tax purposes, to deduct any expense normally taken into account in determining the profit of a business, with certain specific exceptions. But the law does not permit a deduction for expenses incurred by an employee in earning wages or a salary except a few items such as union dues and travel costs incurred by a person who must travel as he performs his work. This contrast in the law has been a long-standing grievance on the part of working men. It was seriously criticized by the royal commission as unfair to employees. The commission recommended that expenses be deductible from wages or

salaries just as they are from business income if "reasonably related to the earning of income." Recognizing, however, that huge numbers of employees are subject to tax and that few keep books or records to prove their expenses, the commission concluded that some means must be found to make compliance feasible for the taxpayer and administration feasible for the revenue department. They proposed offering an option to employees permitting them to claim, in place of detailed expenses, an allowance equal to 3 per cent of their gross employment income, up to a specified maximum.

2.11 The government has considered this issue at length. It proposes two sets of measures to remedy the disparity. First, in regard to those in business and the professions, and to certain types of benefits granted by employers to senior employees, it intends to set more rigorous limits to check "expense account living." The costs of attending conventions and belonging to clubs would no longer be permitted as a charge in determining business income. The costs of yachts, hunting and fishing lodges or camps, amounts spent for tickets for games and performances, and costs of entertainment would also be excluded. Owners or employees of a business having a car or aircraft available to them for their personal use, including travel to and from home, would have to pay the business a minimum stand-by charge, or have a corresponding amount added to their personal income for tax purposes.

2.12 As its second measure, the government proposes to make more provision in the law for the expenses legitimately incurred in earning wages or salaries. However, it has reached the conclusion that claims for expenses on the broad basis suggested by the commission would either impose record-keeping on millions of employees or deny them the ability to submit acceptable claims. It would also produce an impossible processing task in tax administration with inevitable long delays in making refunds. Consequently the government proposes that general limits be retained on expenses that can be deducted from employment income but that a general deduction be provided and somewhat greater recognition given to special situations where employees have to live for a period of time at a work site away from home.

2.13 It is proposed to allow a general deduction for employment expenses, similar to the option proposed by the commission but with a lower maximum. The government believes these expenses are not generally as high as implied by the commission. It would be costly, and inequitable to others, to permit substantially more to be deducted by means of a formula than was normal in typical cases. Consequently it is proposed that the general deduction allowed for expenses incurred in earning employment income be 3 per cent of gross employment income up to a maximum of $150 per year.

2.14 The government proposes to allow unemployment insurance contributions as a deduction from income and to tax benefits received as explained in paragraph *2.22*.

2.15 A deduction would be allowed for the expenses taxpayers often must incur when they move from one job to another. The expenses of moving from one residence to another in these circumstances would be deductible provided that the taxpayer moves to a location at least 10 miles closer to his new job. The deduction would be permitted only from the income earned from working in the new locality.

Other Deductions and Exemptions

2.16 The law now permits a taxpayer to claim the exemption of a married person under certain circumstances even though not married or married but separated. It is proposed to continue this special use of the exemption only for those who support a child or other relative who lives with the taxpayer. Where they live elsewhere, only the deduction for supporting the dependant would be allowed, plus the new child care deduction, if it applies. The provision that permits both a married exemption and a deduction for dependants to be claimed where a fulltime servant is employed would be dropped as unnecessary in view of the new child care deduction. The married exemption would also be discontinued for an unmarried clergyman who employs a fulltime servant and maintains a self-contained domestic establishment.

2.17 It is necessary to reduce the extra exemption for married status where the wife or husband

of the taxpayer has an income and to reduce the deduction for children or other dependants where they have an income of their own. This should be done gradually by reference to the income of the dependant so there is no abrupt dividing line causing unfairness between those just over and just under it. For this purpose it is proposed that the additional exemption of $1,400 for a married man be reduced by $1 for every $1 that his wife's income exceeds $100, so that he would be taxed as a single person when her income is just enough to make her taxable. The same rule would apply where a wife supports her husband. In the case of children under 16, for whom the deduction is $300 (and for whom family allowances are normally payable) it is proposed that the parent's deduction be reduced by $1 for every $2 of income of the child in excess of $900, so that the deduction would disappear when the child is taxable on his own income. For older children and other dependants, for whom the deduction is $550, the taxpayer's deduction would be reduced by $1 for every $1 that the dependant's income exceeds $950, so that this deduction too would disappear when the "dependant" becomes taxable. The amount of $950 is used in the present rule for dependants but the deduction is abruptly cut off when income exceeds this level. In determining the income of a student, for this purpose as well as for his own taxable income, tuition fees may be deducted.

2.18 An additional amount of $500 is currently added to the personal exemption for a person over 70, or for a blind person, or for a person confined to a wheelchair. Although the royal commission recommended that this be cancelled, it is proposed to continue this additional exemption for such taxpayers on compassionate grounds. It can be argued that this is not the best way to assist the incapacitated or the elderly but most of the incapacitated benefiting from this provision have relatively small incomes, and taxpayers' needs tend to increase with age.

Charitable Donations

2.19 It is proposed to continue existing deductions and arrangements for charitable donations. Important improvements have been made in these arrangements in recent years. We propose to add national amateur athletic associations as prescribed by regulation to the list of eligible charitable organizations.

Medical Expenses

2.20 Now that medical care as well as hospital care are covered by comprehensive public plans supported to a large extent by federal expenditures, it is proposed to change somewhat the basis on which medical expenses may be claimed. No expenses paid or recoverable from such public plans now are included in medical expenses for purposes of the Income Tax Act, nor any premiums paid by taxpayers toward such plans. The first provision is necessary to reflect the fact that such plans are already supported out of federal revenue; the second is essential for fairness because some provinces finance their plans largely from general revenue, which cannot be identified or allowed as a deduction, and others by premiums of various sizes. It is now proposed, as the royal commission recommended, that all medical expenditures for which a taxpayer has been reimbursed, or is entitled to be reimbursed, from an insurance or prepayment plan should not be classed as medical expenses for tax purposes. Instead premiums or contributions paid to plans other than government plans would be classed as medical expenses for this purpose. Medical expenses not recoverable from either public or private plans would continue to be deductible where they exceed 3 per cent of the taxpayer's income. One other change in the law will also be proposed to place contributions to public medical care plans on the same basis as contributions to public hospital care plans. This would provide that an employer's contributions on behalf of an employee be treated as a taxable benefit received bv the employee.

Additional Elements of Income to be Subject to Tax

2.21 Other forms of income now exempt from taxation in addition to capital gains must be treated as taxable items in a realistic, reformed structure. This would make the tax fairer in its distribution.

2.22 The most important of these changes would make unemployment insurance benefits taxable and make employees' contributions to the Unemployment Insurance Fund deductible from income. Many employees receive unemployment insurance benefits for part of a year although they may have earned substantial other income during the rest of the year. Tax exemption for these payments is unfair to the person who earns the same total income but who must pay more tax. The higher the employee's regular income the greater the advantage of the present tax-exempt treatment of benefits.

2.23 Social assistance payments to those in need would not be taxed if made under federal or provincial legislation or by a registered charitable organization subject to a needs test or means test. The test would be sufficient evidence of inability to pay, and the circumstances of those to whom the payments are made would normally make reporting of income and assessment of tax impractical. On the other hand, systematic payments under the Old Age Security Act should continue to be included in income, although in practice the new personal exemptions would free them from tax where they are a taxpayer's only income.

2.24 Until now most fellowships, scholarships, bursaries and research grants not related to services have been treated as exempt from tax. There seems no valid reason for continuing such exemption. Post-graduate students and research workers are, in effect, professional workers and should pay tax as others, after allowances for tuition fees and for research expenses properly deductible from research grants. Payments to undergraduates normally fall well within the personal exemptions, after deducting tuition fees. Where they exceed exemptions or where the student has other income, he should pay tax just as other Canadians do.

2.25 With unemployment insurance benefits and student bursaries becoming part of income subject to tax, the same should be true of adult training allowances paid under the Adult Occupational Training Act. The allowance paid to trainees for living away from home would not be included in their income.

2.26 Under our tax treaties with Britain, the United States and a number of other countries, professors and teachers who have come to Canada temporarily are exempt from Canadian income tax on their teaching salaries for two years. In some circumstances they are not taxed by the country where they are normally resident. Given the present scale of salaries of professors and teachers this arrangement is unjustified. We intend to remove this exemption, on a reciprocal basis, from our treaties and to tax such persons like others.

2.27 A special section of the Income Tax Act permits members of the armed services to be taxed under regulations on a monthly basis. For simplicity of administration various short cuts and adjustments are made in determining their income and taxes. This leads to some special benefits for some members of the forces. Under present circumstances members of the forces can be taxed on the same basis as other Canadians and it is our intention to do so.

Changes in Rate Schedule

2.28 The changes proposed above in basic exemptions, the deduction for expenses of earning income, the requirement that additional items must be included in income and the other changes would substantially alter the amount of income to be subject to tax. The combined effect of the increase in basic exemptions and the 3-per-cent deduction from employment income would be that an individual with income entirely from employment would not have to pay tax unless his income exceeds $1,546 if he is single or unless it exceeds $2,990 if he has a full married deduction. The deduction for child care expenses would reduce the tax payable by working wives and, in some cases, by reducing the wife's income, would also leave her husband with a larger exemption for married status.

2.29 The proposed additional deductions from income exceed by a wide margin the amounts to be added to income. The most important change is the increase in basic exemptions. This would reduce taxes substantially on those with higher incomes unless offset by rate changes. The wealthy would be

freed from paying high rates of tax on amounts of income equal to the exemption increases. For example, the increase of $800 in the exemption for married taxpayers could save a high-income person over $659 at current rates and a low-income person only about $118. It would be unfair to revise our system in this way. And the loss of revenue would be substantial, amounting to about $800 million in terms of 1967 incomes.

2.30 The government therefore has decided that along with the increases in exemptions should go a significant increase in the rates applying to the taxable income remaining after all exemptions and deductions.

2.31 In the course of changing the rates the present system should also be greatly simplified. At present the calculation of federal tax on taxable income depends upon no less than six provisions of the act. First, basic tax is calculated using a schedule of graduated rates which starts at 11 per cent on the first $1,000 of taxable income and increases to a top marginal rate of 80 per cent on taxable income in excess of $400,000. To this must be added an old age security tax of 4 per cent, with a ceiling of $240 reached at $6,000 of taxable income, and a social development tax of 2 per cent, with a ceiling of $120 also reached at the $6,000 level. The basic tax but not the old age security tax or social development tax is reduced by 20 per cent, but this reduction may not exceed $20. At present there is also a surtax which is 3 per cent of basic tax in excess of $200. Finally, in order to make room for the provinces to impose a personal income tax, the basic tax is abated by 28 per cent in nine provinces and by 50 per cent in Quebec. This higher abatement in Quebec reflects the fact that certain programs financed jointly by federal and provincial governments in other provinces are partly financed by a higher provincial tax in Quebec under arrangements offered originally to all provinces.

2.32 The provinces are free to impose whatever tax they choose but to have their tax collected by the federal government they must impose a tax expressed as a percentage of federal basic tax. All provinces except Quebec impose their tax in this form; most impose their tax at rates higher than the abatement rate. Quebec imposes and collects its own provincial tax.

2.33 The federal government wishes to avoid causing any significant change in provincial revenues through its changes in exemptions and rates. But the present complicated system must be improved. Accordingly, it is proposed to meld the basic rate schedule, the old age security tax, the social development tax, the current surtax and the 20-per-cent reduction into one new schedule of graduated rates which, when used with the increased exemptions, would produce about the same revenue as the aggregate of the present basic tax after abatement and the other taxes on income. The provincial abatement of 28 per cent would be eliminated and the provincial tax would be calculated as a percentage of the whole federal tax. To illustrate:

present calculation

$100 basic tax is abated by 28 per cent to	$ 72	
old age security tax, social development tax, 20 per cent reduction and surtax aggregate approximately	28	
total federal tax	$100	
provincial tax at 28 per cent of basic tax		$28

new calculation

federal tax using new exemptions and rate schedule	$100	
provincial tax at 28 per cent of federal tax		$28

2.34 Under this new system federal tax would be abated by an additional 22 per cent for taxpayers in Quebec as part payment to the province for shared programs so their position would be unaltered. An adjustment would also be necessary for taxpayers not resident in any province. These include taxpayers in the territories and government

employees living outside Canada but deemed to be residents of Canada for tax purposes. At present these taxpayers receive no provincial abatement because they are not subject to a provincial tax. Under the new proposal they would pay tax under the same new rate schedule as taxpayers in the provinces but be charged an additional tax to correspond to the provincial tax.

2.35 Because the new federal schedule of rates would be actual rates, and not abated by 28 per cent to make room for the provincial tax, the rates for some brackets would be lower than the rates in the present schedule. A proper comparison would require the provincial tax to be added to the new comprehensive federal tax.

2.36 Under the proposed new system the provinces would continue to be free to impose a provincial tax at whatever rate they choose. If they wish to continue with tax collection agreements they would impose their tax as a per cent of the federal tax. The new federal rate schedule and the new exemptions would produce a base for provincial taxes approximately the same as the base computed under the present system.

2.37 As part of the simplification of the rate structure the present additional tax of 4 per cent on investment income in excess of $2,400 received from sources outside Canada would be cancelled.

2.38 Bringing capital gains into income alters our approach to rates of income tax in excess of 50 per cent. Taxing capital gains would increase taxes substantially on the well-to-do. It would do this both directly and by making it possible to plug effectively more of the loopholes which can be used to obtain financial benefits in ways not subject to income tax. It is therefore possible and proper to consider what maximum rate of income tax on individuals is desirable in economic terms.

2.39 The royal commission recommended that when capital gains were made taxable and the various loopholes blocked, the maximum rate of tax on income should be 50 per cent. The government does not accept all the theoretical arguments of the commission in favor of this rate. It is impressed, however, with economic arguments for this course. A higher rate, when applied to a comprehensive definition of income including capital gains, would deter savings and the investment of savings, particularly in venturesome enterprises. Moreover, there is a danger that rates higher than 50 per cent applied to the earned income of professional workers and executives would lead to some slackening in their efforts and a desire to take benefits in the form of holidays, retirement pay, and other non-productive and less-taxable forms. Canada needs the full effort of those with outstanding ability. It must compete for such people with other countries where able Canadians can go to live and to work if they wish.

2.40 Nor should top rates of personal income tax be significantly above rates of corporation income tax. A substantial difference provides an incentive for wealthy people controlling corporations to accumulate income in the corporation rather than pay it out as dividends. Means may be found of converting these surpluses into forms that will benefit the owners without attracting personal tax at excessive rates.

2.41 Proposals now before the United States Congress would provide that no more than one-half of any individual's earned income is taken by income tax. This would have some of the same effects as limiting the top rate of tax to 50 per cent. But it would leave a considerable slice of income subject to substantially higher top rates, which in turn would produce some of the undesirable economic effects noted above.

2.42 The government has concluded that as the taxation of capital gains becomes fully effective, and transitional measures in the new system have ceased to be important, top rates of combined federal and provincial personal income tax should be reduced to 50 per cent. The top rates should gradually be reduced from the present levels, in four instalments commencing in the second year in which the new system applies.

2.43 After this change becomes fully effective the rates of tax on those who now report taxable income in excess of $40,000 would be lower than at present but as result of proposed changes in the taxation of corporations and corporate distributions,

restrictions on expense deductions and the inclusion of gains, the amount they have to report as income for tax purposes would be substantially increased. The taxes on capital gains would be paid mainly by those in the higher brackets and after the first few years should produce hundreds of millions of dollars. This increase in the tax base is a far better way of taxing the wealthy than having ostentatiously high rates on an incomplete tax base.

2.44 Taking into account the changes in rates made necessary by the increase in the exemptions, the incorporation of the old age security tax and other separate taxes and the gradual changes arising through the adjustment of the top rates, Tables 1 and 2 show the existing schedule of rates and the proposed new schedule. The top federal rate after the transitional period would be 40 per cent, and the combined federal and provincial rates would be 51.2 per cent in provinces that impose tax at the rate of 28 per cent and correspondingly greater in provinces that impose higher rates. Tables 4 to 6 show the taxes these new rates and new exemptions and the employment deduction would produce applied to various income levels; Tables 7 to 9 show the taxes the new rates and new exemptions would produce where the 3-per-cent employment deduction is not allowed. Table 10 shows the effect of the proposed new deduction for child care expenses.

Pension Plans and Retirement Savings Plans

2.45 For many years our income tax law has permitted contributions to approved pension funds to be deducted from income in calculating tax, and has given tax-free status to earnings on the investments of such plans. Amounts paid out in pensions or other benefits are taxable in full. In 1957, in order to make similar benefits available to self-employed persons or others not in pension plans, Parliament enacted a special section providing for registered retirement savings plans. Under such plans contributions paid into a trust fund are deductible from income for tax purposes, investment earnings on the fund are exempt from tax, and the amount accumulated in the fund must be paid out as an annuity to the taxpayer, or an annuity to him and his wife. Such annuity payments are fully taxable.

2.46 Tax is thus deferred on savings invested in a pension plan or retirement savings plan and also on the yield from these accumulating savings. This is a great advantage over having to save a similar sum out of income from which tax must first be paid out and then to pay tax on the return on the investment. The extent of the advantage depends on the tax rates of the saver at various times, on the rate of return on the investment and on the length of the period until repayment. The royal commission showed that under approved plans it is possible at interest rates of 7 per cent with only 20 years of saving to get a 50-per-cent greater after-tax retirement income than by saving and investing outside such plans. With 40 years of saving, say from age 25 to 65, it is possible to double the after-tax retirement income. This is a valuable tax concession to persons able to take advantage of it. The royal commission recommended that this treatment of approved plans be continued, but on a carefully rationed basis, calculated by reference to the retirement annuity the plan would provide.

2.47 The government believes it desirable to encourage these personal savings plans for retirement. But it must be done on an equitable basis, available to all and subject to fair and reasonable limits. The government also believes that the tax-free trusts for retirement plans should not be entitled to the credit for corporation income tax proposed for dividends on shares in Canadian corporations. Freedom from tax on dividends and interest and capital gains should be sufficient.

2.48 At present, the tax act sets limits on the amount of the contributions to such plans that a taxpayer can deduct each year. As a result, taxpayers who can save regularly throughout their lifetime can provide for larger retirement incomes out of before-tax income than those who are able to save only during limited periods. In principle, the limits on what may be put into such tax-free savings funds by or on behalf of an individual can most fairly be established in terms of the benefit the fund can be expected to provide on retirement. This would equate the position of late savers with that of regular savers.

2.49 Establishing an effective, fair system based on a benefit limit is not easy. There are many different formulas for determining pension benefits, and it is necessary to be able to determine equivalents among these formulas, meanwhile bearing in mind the variety of survivors' benefits and fringe benefits attached to the modern pension plan. Moreover, some of the formulas are based upon contributions rather than earnings. Under these plans it is necessary to take into account the likely yield on investments over a long span of years and the likely increase in one man's pension as a result of other employees leaving and forfeiting part of the funds tentatively at their credit.

2.50 While it is difficult to work out, the government believes in principle that such a system should be established. Unfortunately it is estimated that removal of the contribution limits would be quite expensive, and revenue considerations prohibit a switch at this time. Consequently we propose to retain the existing limits based on contributions, for the present, except for certain types of specified lump-sum payments into registered retirement savings plans. We also propose that plans that are primarily for the benefit of shareholders be denied registration until the switch is made to a benefit limit. The present contribution limits should be sufficient over a period to produce, along with the Canada Pension Plan and the old age security pension, reasonable retirement incomes. We suggest that any limits, whether on contributions or benefits, should be reviewed, perhaps every five years, to see that they are in reasonable accord with changing circumstances and prospects.

2.51 Most pension funds now are subject to regulation under the Pension Benefits Standards Acts of the provinces or of Canada. These control the investments of pension funds in a manner generally adequate for tax purposes. However, it is essential to be sure that tax-free funds cannot be diverted through investment in such a way as to bring current benefits to those who contribute to them and control them, and to provide sanctions to be applied when investments are made contrary to the rules. With adjustment to meet these two points it is proposed that the rules applying to invesment of pension funds be the same as under the provincial and federal laws respecting pension plans. For registered retirement savings plans the permitted range of investments could be somewhat broader.

2.52 Three other changes are also proposed. First, the savings withdrawn from these plans would be taxed at ordinary rates, even if the amounts are withdrawn at the death of the contributor. A widow would be permitted to offset or reduce this income if she contributes all or part of the proceeds to a registered retirement savings plan of her own. Second, rules are required to ensure that the trustees of a pension or retirement plan fund are liable and responsible for paying taxes arising out of its operations. This would be necessary if, for example, beneficiaries leave Canada with the assets. Third, in view of the size and rate of growth of pension and retirement savings funds, due in part to their tax-free status, it is reasonable to require that the bulk of them be productively invested in Canada. Consequently it is proposed that to qualify for the tax-free status of registered pension plans or registered retirement savings plans, these plans must invest no more than 10 per cent of their assets in foreign securities or other foreign investments.

General Income-Averaging Option

2.53 Income tax is levied on a year's income at a time, at a rate that normally depends on the size of that year's income alone. But some types of income are irregular, and tax must be paid at a higher rate in a year when income is abnormally high. This may cause taxpayers with irregular or varying incomes to pay significantly higher taxes over a series of years than those whose incomes are more regular. Special provisions in the existing law permit farmers and fishermen to average their incomes over a block of five years, authors over three years, and businessmen on certain unusual types of income over three or five years. Certain types of single payments out of pension funds, or by employers on retirement of an employee, can be taxed at the average rate of tax paid by the employee over the preceding three years.

2.54 The introduction of a capital gains tax, particularly one in which accrued gains on shares in widely-held Canadian corporations are taxed periodically, would increase the need for a more general averaging formula, because many more taxpayers will occasionally have incomes much higher than their average incomes. The royal commission noted this need under a capital gains tax and recommended for all taxpayers an averaging formula similar to that now available to farmers. It also recommended that "deposit averaging" be permitted, under which a taxpayer could deposit with the government a portion of his income—on an interest-free basis—and pay no tax on it until it was withdrawn.

2.55 The government has reached the view that a general averaging formula should be available to all individual taxpayers. However, it proposes a much simpler and more automatic system than the royal commission did. Averaging would introduce new complications for the taxpayer, and new need for keeping records. Moreover, the system proposed by the commission would confront the taxpayer with difficult choices, and the possibility of choosing a period that would later prove to be against his own interest. The proposed simpler method can be applied automatically by the central tax assessment computer, using the information for previous years stored in its memory. Moreover, it would work smoothly and fairly even when tax rates change. It should also be noted that averaging options can be very expensive in terms of revenue, particularly at a time when incomes are growing rapidly, and there must be safeguards against giving the benefits of averaging to what are simply growing incomes.

2.56 The method proposed is as follows: when the income in the taxation year exceeds the average of the taxpayer's income in the preceding four years by more than one-third, the excess income would be taxed as though it were subject to a graduated rate schedule in which the income brackets to which each rate applied were five times as wide as normal. The formula is necessarily complicated but this would not concern taxpayers because it can be applied on their behalf. Tables 11 and 12 show the application of the formula in more detail.

2.57 It is not proposed to remove the present averaging formula for farmers or fishermen, who would be free to use either system. But a year included in a block of years averaged under the present system could not be used in applying the proposed new formula. Current provisions permitting averaging over a period for special lump-sum business receipts from recaptured capital cost allowance, inventory revaluation, the sale of inventory and the sale of receivables would be phased out. For corporations the phase-out would begin once the transition to one rate of corporate tax is complete. Lump-sum payments out of pension funds, or from employers on retirement, could be averaged on the new formula or, subject to certain safeguards, paid into a registered retirement savings plan, over and above the normal limit on such payments. A similar opportunity to pay extra amounts into registered retirement savings plans might be afforded to those having certain other types of irregular or short-term incomes such as authors and professional athletes. Withdrawals from such registered plans would be fully taxable and made on a regular and controlled basis.

2.58 It would not be possible to bring the general averaging arrangement into effect immediately. It would be necessary to have the records of assessed income for previous years for all or nearly all taxpayers before the system could be fairly used. Until this accumulation of information reaches five years it would be necessary to use a shorter series of years, with a lower "threshold level".

2.59 A second and more serious practical problem is whether years in which there is no taxable income for one reason or another should be counted for averaging, and whether years before such a year of no income should be used. It seems unfair to permit a taxpayer to include in averaging any years in which he or she is claimed as a dependant for purposes of the married exemption. The same is true of students at school or university. Counting such years of no income, or income below the exemption limit, might well reduce tax for several years on people who have chosen to be outside the labour market and in respect of whom dependants' deductions have been granted. It is therefore proposed that a married person may use for averaging only an unbroken series of years after

being claimed as a dependant by his or her marriage partner. A person under 25 years of age could use only an unbroken series of years since the last year in which he had no tax to pay. These rules are not wholly satisfactory, but no simple and practical alternative has been found. Those prevented by such rules from using more than, say, two previous years for averaging might be permitted to assume an arbitrary income of $5,000 per year in the years excluded.

TABLE 1

Present Schedules of Rates Applied to Taxable Income

	Federal Tax		Combined Federal and 28% Provincial Tax	
Taxable Income Bracket	*Tax at the beginning of the bracket*	*Tax rate on income in the bracket*	*Tax at the beginning of the bracket*	*Tax rate on income in the bracket*
$	$	%	$	%
0 – 909	0.00	11.72	0.00	14.80
909 – 1,000	106.55	13.92	134.55	17.00
1,000 – 1,643	119.20	16.08	150.00	20.00
1,643 – 2,000	222.57	16.50	278.57	20.42
2,000 – 3,000	281.50	18.75	351.50	23.51
3,000 – 4,000	469.00	20.25	586.60	25.57
4,000 – 6,000	671.50	22.50	842.30	28.66
6,000 – 8,000	1,121.50	19.50	1,415.50	26.78
8,000 – 10,000	1,511.50	22.50	1,951.10	30.90
10,000 – 12,000	1,961.50	26.25	2,569.10	36.05
12,000 – 15,000	2,486.50	30.00	3,290.10	41.20
15,000 – 25,000	3,386.50	33.75	4,526.10	46.35
25,000 – 40,000	6,761.50	37.50	9,161.10	51.50
40,000 – 60,000	12,386.50	41.25	16,886.10	56.65
60,000 – 90,000	20,636.50	45.00	28,216.10	61.80
90,000 – 125,000	34,136.50	48.75	46,756.10	66.95
125,000 – 225,000	51,199.00	52.50	70,188.60	72.10
225,000 – 400,000	103,699.00	56.25	142,288.60	77.25
400,000 –	202,136.50	60.00	277,476.10	82.40

NOTES: Federal tax includes the old age security tax, the social development tax and the 3% surtax, and is after deducting the 20% reduction (maximum $20) and the provincial abatement of 28% of basic tax.
Combined tax includes the federal tax and a provincial income tax at 28% of basic tax.

TABLE 2

Proposed Schedules of Rates Applied to Taxable Income

Taxable Income Bracket	Federal Tax: Tax at the beginning of the bracket	Federal Tax: Tax rate on income in the bracket	Combined Federal and 28% Provincial Tax: Tax at the beginning of the bracket	Combined Federal and 28% Provincial Tax: Tax rate on income in the bracket
$	$	%	$	%
0 – 500	0	17	0.00	21.76
500 – 1,000	85	18	108.80	23.04
1,000 – 1,500	175	19	224.00	24.32
1,500 – 2,000	270	20	345.60	25.60
2,000 – 3,000	370	21	473.60	26.88
3,000 – 4,000	580	22	742.40	28.16
4,000 – 5,000	800	24	1,024.00	30.72
5,000 – 7,000	1,040	26	1,331.20	33.28
7,000 – 10,000	1,560	28	1,996.80	35.84
10,000 – 13,000	2,400	30	3,072.00	38.40
13,000 – 16,000	3,300	33	4,224.00	42.24
16,000 – 24,000	4,290	36	5,491.20	46.08
24,000 –	7,170	40	9,177.60	51.20

The above will be the effective rates after five years in provinces that levy a provincial income tax at 28% of federal tax. During the first four years (during which period the revenue from taxing capital gains will increase significantly year by year) there will continue to be federal rates in excess of 40% and combined rates in excess of 51.2%.

In the first year of the new system the additional brackets will be as set out below. In each of years two, three, four and five, each rate will be reduced by one-quarter of the excess over 40% and 51.2%.

24,000 – 35,000	7,170	40	9,177.60	51.20
35,000 – 55,000	11,570	44	14,809.60	56.32
55,000 – 85,000	20,370	48	26,073.60	61.44
85,000 – 120,000	34,770	52	44,505.60	66.56
120,000 – 200,000	52,970	56	67,801.60	71.68
200,000 – 400,000	97,770	60	125,145.60	76.80
400,000 –	217,770	64	278,745.60	81.92

TABLE 3

Present Basic Personal Income Tax Exemption in Canada and Other Countries
(all money figures in $ Canadian)

Country	*Deduction for single status*	*Deduction for married status*	*Additional minimum standard deduction for all taxpayers*
	$	$	$
Canada	1,000	2,000	100
U.S.A. (U.S.$ = $1.078)	647	1,294	323 (single) 431 (married)
U.K.[1] (£ = $2.571)	656	965	—
West Germany[2] (DM = $.271)	464	928	—
Sweden (Kr. = $.2083)	469	938	—
New Zealand (NZ$ = $1.203)	331	620	—
Australia[3] (A$ = $1.20)	nil	374	—

1 In the U.K. each spouse is allowed a basic earned income allowance and also a small income relief in addition to the basic deduction. These have the effect of exempting from tax some incomes in excess of the amounts shown above.

2 In Germany the deductions shown above are provided in the rate schedule.

3 In Australia an individual with income of less than $499 is not required to pay income tax.

TABLE 4

Effect of New Exemptions, New Rate Schedule and New Deduction from Employment Income

	Single taxpayer—no dependants		
Income before exemptions or deductions	*Present federal tax and 28% provincial tax*	*New federal tax and 28% provincial tax*	*Reduction (−) or increase (+)*
$	$	$	$
1,200	15	—	− 15
1,400	44	—	− 44
1,600	74	11	− 63
1,800	104	54	− 50
2,000	133	96	− 37
2,500	230	207	− 23
3,000	331	324	− 7
4,000	563	576	+ 13
5,000	817	841	+ 24
6,000	1,100	1,132	+ 31
8,000	1,657	1,780	+ 124
10,000	2,229	2,481	+ 251
12,000	2,894	3,206	+ 313
15,000	4,073	4,372	+ 299
20,000	6,334	6,574	+ 240
25,000	8,651	8,878	+ 227
30,000	11,170	11,405	+ 235
50,000	21,928	22,328	+ 400
100,000	52,715	53,391	+ 677
	After reduction of top rates		
30,000	11,170	11,405	+ 235
50,000	21,928	21,645	− 283
100,000	52,715	47,245	−5,470

It is assumed that all income is from employment and that a deduction of 3 per cent with a maximum of $150 is made from income. No account has been taken of other proposed adjustments to income.

The present federal tax includes the old age security tax, the social development tax and the 3 per cent surtax.

The taxpayer is assumed to take the optional standard deduction of $100.

By the time the reduction of top rates comes into effect persons with incomes in these brackets can normally be expected to have larger amounts subject to tax because of the inclusion of capital gains.

TABLE 5

Effect of New Exemptions, New Rate Schedule and New Deduction from Employment Income

Income before exemptions or deductions	Married taxpayer—no dependants		
	Present federal tax and 28% provincial tax	*New federal tax and 28% provincial tax*	*Reduction (−) or increase (+)*
$	$	$	$
2,200	15	—	− 15
2,400	44	—	− 44
2,600	74	—	− 74
2,800	104	—	− 104
3,000	133	2	− 131
3,500	230	108	− 122
4,000	331	219	− 112
5,000	563	461	− 102
6,000	817	729	− 88
8,000	1,387	1,316	− 71
10,000	1,924	1,980	+ 56
12,000	2,538	2,696	+ 157
15,000	3,661	3,821	+ 160
20,000	5,870	5,929	+ 59
25,000	8,188	8,233	+ 45
30,000	10,655	10,688	+ 33
50,000	21,361	21,540	+ 178
100,000	52,045	52,460	+ 414
	After reduction of top rates		
30,000	10,655	10,688	+ 33
50,000	21,361	20,928	− 433
100,000	52,045	46,528	−5,517

It is assumed that all income is from employment and that a deduction of 3 per cent with a maximum of $150 is made from income. No account has been taken of other proposed adjustments to income.

The present federal tax includes the old age security tax, the social development tax and the 3 per cent surtax.

The taxpayer is assumed to take the optional standard deduction of $100.

By the time the reduction of top rates comes into effect persons with incomes in these brackets can normally be expected to have larger amounts subject to tax because of the inclusion of capital gains.

TABLE 6

Effect of New Exemptions, New Rate Schedule and New Deduction from Employment Income

	Married taxpayer—two dependent children under age 16		
Income before exemptions or deductions	*Present federal tax and 28% provincial tax*	*New federal tax and 28% provincial tax*	*Reduction (−) or increase (+)*
$	$	$	$
2,800	15	—	− 15
3,000	44	—	− 44
3,500	118	—	− 118
4,000	210	83	− 127
4,500	311	193	− 118
5,000	422	309	− 113
6,000	663	568	− 96
8,000	1,215	1,132	− 83
10,000	1,764	1,780	+ 17
12,000	2,353	2,481	+ 128
15,000	3,414	3,590	+ 177
20,000	5,592	5,652	+ 60
25,000	7,910	7,956	+ 47
30,000	10,346	10,381	+ 35
50,000	21,022	21,202	+ 180
100,000	51,643	52,060	+ 417
	After reduction of top rates		
30,000	10,346	10,381	+ 35
50,000	21,022	20,621	− 401
100,000	51,643	46,221	−5,423

It is assumed that all income is from employment and that a deduction of 3 per cent with a maximum of $150 is made from income. No account has been taken of other proposed adjustments to income.

The present federal tax includes the old age security tax, the social development tax and the 3 per cent surtax.

The taxpayer is assumed to take the optional standard deduction of $100.

By the time the reduction of top rates comes into effect persons with incomes in these brackets can normally be expected to have larger amounts subject to tax because of the inclusion of capital gains.

TABLE 7

Effect of New Exemptions and New Rate Schedule

Income before exemptions or deductions	Single taxpayer—no dependants: *Present federal tax and 28% provincial tax*	*New federal tax and 28% provincial tax*	*Reduction (−) or increase (+)*
$	$	$	$
1,200	15	—	− 15
1,400	44	—	− 44
1,600	74	22	− 52
1,800	104	65	− 38
2,000	133	109	− 24
2,500	230	224	− 6
3,000	331	346	+ 15
4,000	563	608	+ 45
5,000	817	883	+ 66
6,000	1,100	1,178	+ 77
8,000	1,657	1,830	+ 174
10,000	2,229	2,534	+ 305
12,000	2,894	3,264	+ 370
15,000	4,073	4,435	+ 362
20,000	6,334	6,643	+ 309
25,000	8,651	8,947	+ 296
30,000	11,170	11,482	+ 312
50,000	21,928	22,413	+ 485
100,000	52,715	53,491	+ 777
	After reduction of top rates		
30,000	11,170	11,482	+ 312
50,000	21,928	21,722	− 206
100,000	52,715	47,322	−5,393

It is assumed that all income is from sources other than employment. No account has been taken of capital gains or other proposed adjustments to income, or of credits in respect of dividends from Canadian corporations.

The present federal tax includes the old age security tax, the social development tax and the 3 per cent surtax.

The taxpayer is assumed to take the optional standard deduction of $100.

By the time the reduction of top rates comes into effect persons with incomes in these brackets can normally be expected to have larger amounts subject to tax because of the inclusion of capital gains.

TABLE 8

Effect of New Exemptions and New Rate Schedule

	Married taxpayer—no dependants		
Income before exemptions or deductions	*Present federal tax and 28% provincial tax*	*New federal tax and 28% provincial tax*	*Reduction (−) or increase (+)*
$	$	$	$
2,200	15	—	− 15
2,400	44	—	− 44
2,600	74	—	− 74
2,800	104	—	− 104
3,000	133	22	− 111
3,500	230	132	− 98
4,000	331	248	− 83
5,000	563	500	− 63
6,000	817	771	− 46
8,000	1,387	1,364	− 23
10,000	1,924	2,033	+ 108
12,000	2,538	2,749	+ 211
15,000	3,661	3,878	+ 217
20,000	5,870	5,998	+ 128
25,000	8,188	8,302	+ 114
30,000	10,655	10,765	+ 110
50,000	21,361	21,624	+ 263
100,000	52,045	52,559	+ 514
	After reduction of top rates		
30,000	10,655	10,765	+ 110
50,000	21,361	21,005	− 357
100,000	52,045	46,605	−5,440

It is assumed that all income is from sources other than employment. No account has been taken of capital gains or other proposed adjustments to income, or of credits in respect of dividends from Canadian corporations.

The present federal tax includes the old age security tax, the social development tax and the 3 per cent surtax.

The taxpayer is assumed to take the optional standard deduction of $100.

By the time the reduction of top rates comes into effect persons with incomes in these brackets can normally be expected to have larger amounts subject to tax because of the inclusion of capital gains.

TABLE 9

Effect of New Exemptions and New Rate Schedule

Income before exemptions or deductions	*Married taxpayer—two dependent children under age 16*		
	Present federal tax and 28% provincial tax	*New federal tax and 28% provincial tax*	*Reduction (−) or increase (+)*
$	$	$	$
2,800	15	—	− 15
3,000	44	—	− 44
3,500	118	—	− 118
4,000	210	109	− 101
4,500	311	224	− 87
5,000	422	346	− 76
6,000	663	608	− 55
8,000	1,215	1,178	− 37
10,000	1,764	1,830	+ 67
12,000	2,353	2,534	+ 182
15,000	3,414	3,648	+ 234
20,000	5,592	5,722	+ 129
25,000	7,910	8,026	+ 116
30,000	10,346	10,458	+ 112
50,000	21,022	21,286	+ 265
100,000	51,643	52,160	+ 517
	After reduction of top rates		
30,000	10,346	10,458	+ 112
50,000	21,022	20,698	− 324
100,000	51,643	46,298	−5,346

It is assumed that all income is from sources other than employment. No account has been taken of capital gains or other proposed adjustments to income, or of credits in respect of dividends from Canadian corporations.

The present federal tax includes the old age security tax, the social development tax and the 3 per cent surtax.

The taxpayer is assumed to take the optional standard deduction of $100.

By the time the reduction of top rates comes into effect persons with incomes in these brackets can normally be expected to have larger amounts subject to tax because of the inclusion of capital gains.

TABLE 10

Effect of New Exemptions, New Rate Schedule and New Deductions for Employment Expenses and Child Care

Income before exemptions or deductions		*Married taxpayers—two dependent children under age 16*		
		Present federal tax and 28% provincial tax of family	*New federal tax and 28% provincial tax of family*	*Reduction (−) or increase (+)*
Husband $	*Wife* $	$	$	$
2,000	1,000	7	—	− 7
3,000	2,000	223	54	− 169
4,000	3,000	753	506	− 247
5,000	4,000	1,226	992	− 235
6,000	5,000	1,745	1,521	− 224
7,000	5,000	2,032	1,822	− 210
8,000	5,000	2,313	2,148	− 164
9,000	5,000	2,580	2,481	− 99
10,000	5,000	2,861	2,833	− 27
12,000	5,000	3,494	3,550	+ 56
15,000	5,000	4,642	4,696	+ 53

It is assumed that all income is from employment and that each taxpayer deducts 3 per cent of income with a maximum of $150. The maximum deduction in respect of child care has been made from the wife's income.

The present federal tax includes the old age security tax, the social development tax and the 3 per cent surtax.

Both taxpayers are assumed to take the optional standard deduction of $100.

TABLE 11

Operation of Averaging Formula for Individuals

Assume that a married taxpayer with no dependants has income as follows:

1971	$ 8,000
1972	9,000
1973	9,000
1974	10,000
1975	22,000

Income calculations:

Average of years 1971 to 1974 inclusive	$ 9,000
Threshold amount is average income plus one-third	12,000
Excess of income in 1975 over threshold amount	10,000
Divide this excess by 5	2,000
Add this 1/5 excess to threshold amount ($12,000 + $2,000)	14,000

Tax calculations:

Tax on $14,000	$ 3,494
Tax on threshold amount	2,749
Difference is tax on 1/5 excess	745
Multiply tax on 1/5 excess by 5 = tax on excess	3,725
Tax on threshold amount	2,749
Total is tax on income of $22,000 in 1975	$6,474

The tax on income of $22,000 in 1975 without averaging would be $6,920. Thus the tax saving from averaging in this example is $446.

If the income in the above example for the year 1975 were $32,000 the saving from averaging would be $1,455. Unless the taxpayer's income in 1975 exceeds $12,900 there would be no saving from averaging.

Table 12 gives some further examples of the results from using this averaging formula.

TABLE 12

Operation of Averaging Formula for Individuals

	1971	1972	1973	1974	1975
	$	$	$	$	$
Example 1					
Income	2,100	2,100	2,100	2,100	8,000
Excess of income in 1975 over average of previous four years					5,900
Tax saving from averaging					314
Example 2					
Income	2,000	2,000	6,000	8,000	10,000
Excess of income in 1975 over average of previous four years					5,500
Tax saving from averaging					136
Example 3					
Income	6,000	6,000	6,000	6,000	15,000
Excess of income in 1975 over average of previous four years					9,000
Tax saving from averaging					185
Example 4					
Income	10,000	6,000	9,000	11,000	18,000
Excess of income in 1975 over average of previous four years					9,000
Tax saving from averaging					173
Example 5					
Income	15,000	15,000	15,000	15,000	40,000
Excess of income in 1975 over average of previous four years					25,000
Tax saving from averaging					671

For these calculations it is assumed that the taxpayer is married with no dependants and has no other deductions except the $100 standard deduction. The proposed new rates and basic exemptions are used and it is assumed that the provincial tax is 28 per cent.

3

Capital Gains as Income

3.1 The government proposes that capital gains be taxed. We recognize that this would be a major and controversial step, but we have concluded that the step must be taken if Canada's tax system is to be fair, and if it is to be effective.

3.2 A Canadian who is able to realize a substantial stock market profit or real estate gain clearly has an increased ability to pay; he is better able to pay for a new car, or to pay for stocks and bonds, or to pay income taxes, than is his neighbor who has not had such a gain. At present, Canada does not tax this ability to pay. As a result, some very well-to-do Canadians pay far less tax than others with similar abilities to pay, and less even than others with much lower incomes (all because these particular Canadians receive a large part of their income as "capital gains"). Moreover, it has been possible for the sophisticated to arrange their transactions in such a way that they receive as capital gains amounts that would have been income had the transaction been carried out in the normal manner.

3.3 The government rejects the proposition that every increase in economic power, no matter what its source, should be treated the same for tax purposes. This proposition, put forward forcefully by the Royal Commission on Taxation, has often been summarized rather inelegantly as "a buck is a buck is a buck." But although the government does not accept this theory in all its splendid simplicity, neither does it believe that the distinction between a so-called "capital gain" and an income receipt is either great enough or clear enough to warrant the tremendous difference between being completely exempt and being completely taxable.

3.4 If a corporation which earns a large profit distributes that profit to its shareholders, the present system classifies those distributions as income and levies an income tax on them, just as it does on wages and salaries. On the other hand, if the corporation does not distribute the profits, the value of shares in the corporation will almost certainly increase. If a shareholder realizes on his share of that increase by selling his shares at a profit, the present system usually classifies that profit as a capital gain and it is tax-exempt.

3.5 Again, if a taxpayer in the logging business decides to sell out after he logs his last timber limit, the profit from logging that last limit is taxable income. However, if he decides to sell out before he logs that limit, and if he makes a profit on the sale of the limit, the profit may well be a capital gain.

3.6 These examples indicate how little difference there is between many capital gains and taxable income. The form of the transactions differs, but the nature of the income does not. There are other capital gains, however, where the similarity is not nearly as strong. If a Canadian sells his home for more than he paid for it, he has realized a capi-

tal gain. As a result, he is better off than a neighbor who has been a tenant. Nevertheless, the government does not feel that it would be appropriate to treat the homeowner's gain as ordinary income. Home ownership is part of the Canadian way of life, and within reasonable limits the profit on the sale of a personal residence would be treated as a recovery of the personal expenses of the homeowner.

3.7 The present exemption of capital gains has resulted in an unfair distribution of the tax burden. This has undermined the progressive nature of the income tax system. Because the well-to-do have more capital than those who are less well off, they naturally have more capital gains. Statistics from the United States and the United Kingdom indicate that the well-to-do receive a much higher proportion of their purchasing power—their ability to pay—from capital gains than do those with lower incomes. The result is that the effective tax rate paid by high-income taxpayers as a group is significantly lower than the rate schedule would lead one to expect.

3.8 The present exemption has also led to an unfair tax load on those high-income Canadians who do not have capital gains. In an attempt to be sure that the rich as a class pay a higher proportion of their income as tax than do the less well off, governments have imposed very high rates on the part of their income that is taxed. The top marginal rate in the Canadian rate schedule is 80 per cent—82.4 per cent if the 3-per-cent surtax is added. When provincial income taxes are also taken into account, the top marginal rate is even higher in six provinces. These high rates contrast sharply with the rate of 50 per cent (approximately 51.5 per cent with the surtax) which is applied to the income of corporations, including the largest corporations with incomes of millions of dollars.

3.9 It is very difficult to appraise the effects of these high marginal income tax rates on work effort and on decisions concerning staying in Canada, or moving to Canada. Many factors enter into such decisions, and income tax rates may well not be the most significant factor. But if a tax rate of 60 per cent or 80 per cent is influential, it is clear which way it would tip the decision, particularly when these high rates apply to the additional income of people who already are quite well off. In any event, the taxation of capital gains would make possible a more progressive tax system than at present without resorting to the very high rates now in use.

3.10 The exemption for capital gains has also encouraged taxpayers to make determined and persistent efforts to receive their income in that form, since then it would not bear tax. This tendency was well illustrated by the rash of "surplus-stripping" in the late 1950s and early 1960s. Privately-owned companies had accumulated many years' earnings, which would have been taxable in the shareholders' hands if distributed in the normal manner, as dividends. A good number of taxpayers went through a series of complicated transactions of one sort or another in an attempt to realize on the accumulated profits tax-free. A key element in most of these complicated transactions was a sale by the shareholders of their shares; a sale which the shareholders claimed gave rise to a tax-free capital gain.

3.11 Because the line between taxable income and tax-exempt capital gain is not clear-cut, the present system leads to uncertainty. In some instances, a taxpayer may be uncertain whether he has succeeded in transforming income into capital gains. In a much larger number of cases, Canadians are offered a price for something that they own, and are unable to determine whether the transaction is taxable. This uncertainty is probably greatest if the asset involved is land, and follows naturally from the nature of the tests applied to determine whether a transaction results in taxable income or a capital gain.

3.12 The most important test involves the owner's intention when he bought the property. If he bought with the intention of selling later at a profit—or if that was one of the things he had in mind—the profit is taxable income. On the other hand, if he bought it for his personal use (for example, to build a home on it) or to obtain an annual income from it (for example, by building a duplex or apartment building on it) the profit is likely a capital gain. The taxpayer must know not only what his intention was. Much more important, he must know what the tax assessor, and perhaps subsequently the

courts, will decide that his intentions were. It is not surprising that there are many disputes.

The Proposal

3.13 The government proposes that capital gains be subjected to a progressive tax as part of the general income tax system. Depending on the nature of the asset, all or part of the gain would be included in income and taxed at the taxpayer's marginal rate. Similarly, all or part of capital losses suffered by a taxpayer would be deductible from taxable income and so save the taxpayer tax at his marginal rate. It would be necessary to prohibit the deduction of losses which are in fact the result of personal consumption: for example, the loss on a sale of the family car.

3.14 If capital gains are included in income for tax purposes, the portion of the total income of the well-to-do that is brought to tax would be dramatically increased. As previously mentioned, the income tax system would become significantly more progressive, and we would no longer need the very high rates of tax in order to have a fair system.

3.15 The government does not propose to tax gains that arise before the new system is introduced unless those gains would have been taxed under the present system. Consequently, the general rule would be that taxpayers could deduct from the proceeds of sale of assets the value of those assets on "valuation day". Consider the case of the taxpayer who bought a block of shares in 1964 for $1,500 which today is worth $2,500. If the new system were to go into effect with today as valuation day, and if the taxpayer were to sell his shares a year from now for $2,600, his taxable gain would be only $100. If he were to sell them for $2,100, he would have a loss for tax purposes of $400.

3.16 The natural and ordinary thing to do would be to proclaim that valuation day is to be the day on which the new system is to begin. However, if that were done, the pressure on market prices on that day could be tremendous, and the opportunities for price-fixing too great. To avoid these consequences, the government proposes to choose a day close to the beginning of the system and to announce that evening that it was valuation day.

3.17 Once the tax on capital gains had been part of the system for a few years, taxpayers would begin to report gains that had accrued over several years. In the absence of special provisions, this could result in a much larger than usual income in that year and could make the taxpayer liable for a marginal rate of tax considerably higher than the rates that would have applied had his income been spread over the years during which the gain accrued. The averaging provisions described in Chapter 2 would overcome this effect.

3.18 As stated, all or part of the capital gain would be treated as income, depending upon the type of asset involved. The general rule would be that capital gains would be fully taxable. However, special rules would be provided to reduce the tax in the case of a taxpayers' principal residence, other property held for personal use or enjoyment, and shares of widely-held Canadian public corporations. Special rules would also reduce the tax on the sale of bonds and mortgages which are held on the day this White Paper is published. These rules, and the special rules concerning losses, are explained in the following paragraphs.

Principal Residences

3.19 Generally, capital gains on the sale of homes would not be taxed. This would be accomplished by providing that when a taxpayer sells his principal residence only the profit in excess of $1,000 per year of occupancy would be taxed, and by granting the "rollover" discussed in the next paragraph. Both of these provisions would of course apply on the sale of a farm with farmhouse that has been a principal residence. The $1,000 per year exemption would also compensate for the fact that losses on the sale of a taxpayer's residence other than a farmhouse sold with the farm, would not be deductible from income for tax purposes. The government believes it would be virtually impossible to distinguish between losses which arise from changes in the real estate market and losses which

arise from the aging of the house and normal wear and tear. Naturally in calculating his profit the taxpayer would be able to take into account the cost of the improvements he has made. If he does not bother to keep records, he would be allowed instead a home improvement allowance of $150 per year of occupancy.

3.20 In addition to the exemption, the government proposes that a taxpayer who moves from one area to another within Canada in connection with a change of job should be entitled to treat the sale of his home and the purchase of a home in the new area as a non-taxable transaction. In technical terms, he would be granted a "rollover". If the taxpayer spends the proceeds of the sale of one house on the purchase of another within a year from the date of the sale, any profit that would be taxable on the sale of the old house (that is, after deducting the exemption) would be deducted from the cost to him of the new house. In this way, the profit would increase his gain on the ultimate sale of his new house (or reduce his loss), and tax would not be due before that time.

3.21 A taxpayer who has two homes could only claim the exemption or the rollover with respect to one of them. He would have to declare which is his principal residence. Similarly, a husband and wife would have to choose one principal residence for both of them, unless they are separated pursuant to a divorce, judicial separation or written separation agreement.

Other Property held for Personal use or Enjoyment

3.22 This category would include such things as cars, boats, stamp collections, paintings, sculptures and cottages, etc. It might, therefore, include assets that the owner hopes can be resold later for more than they cost after he has had the use or enjoyment of them for a time.

3.23 If all profits on this type of asset were to be taxable, Canadians would have to become a nation of bookkeepers. The government proposes a rule which should have the effect of significantly reducing this record-keeping. When a taxpayer sells such an asset, he would not be taxed unless the proceeds exceed $500. If the proceeds do exceed $500 he could deduct from those proceeds either his cost or $500 whichever is the greater. This would have the result that Canadians need keep a record of the purchase of items of this type of personal property only if the cost of the item exceeds $500. To protect the revenue it would be necessary to provide that a series of sales of items of a set would be treated as one sale in applying the $500 limit.

3.24 As a companion to the $500 rule on gains, losses would not be deductible unless the item sold cost more than $500. If an asset did cost more than $500, the deductible loss would be computed by deducting from the cost either the proceeds or $500, whichever is greater.

3.25 Because this category of assets involves items bought for personal use or enjoyment, it would also be necessary to impose some over-all limitations on the deductibility of losses. Otherwise, some taxpayers could reduce their taxable income by deducting personal expenses. Therefore, the government proposes that if an item in this category is of the nature that it depreciates through use, a loss on the sale of this item would not be deductible. Examples of this type of asset would include furniture, cars, boats and cottages held for personal use.

3.26 A second type of asset within the general category does not decrease in value through use. In this group one would include paintings, sculptures, jewellery and coin and stamp collections. However, in order to recognize the personal nature of these assets and of the losses resulting on their sale, the government proposes that such losses be deducted only from gains realized on the sale of the same type of asset. If the taxpayer does not have enough taxable gains of this nature in the same year to absorb the deductible loss, the balance could be offset against such gains either in the immediately preceding year or in the year immediately following.

3.27 These rules would of course not apply to persons who are in the business of buying and selling this type of asset. Dealers would continue to be taxable on their profits and entitled to deduct their

losses within the limits which apply to business losses. There would be cases where it would be difficult to determine when a hobby has become a business. This difficulty exists at present and has not been particularly acute with respect to this type of asset.

Investments other than Shares

3.28 This category would involve investments such as bonds, mortgages, agreements for sale, and rental real estate. It is proposed that profits from the sale of these assets be brought fully into taxable income and that losses on the sale of assets of this type be fully deductible in computing taxable income. Taxpayers who obtain bonds, mortgages and agreements for sale at a discount with a low coupon yield would be in the same position as taxpayers who buy at par with a higher coupon yield.

3.29 The general rule that taxpayers would not be taxed on more than the increase in value of such investments after valuation day would apply to these assets. Further, if bonds, mortgages and agreements for sale that a taxpayer now holds are worth less on valuation day than the taxpayer's cost—or his "amortized" cost if he bought it at a discount—the recovery of cost or amortized cost would not be treated as income. For example, if a taxpayer bought a 6-per-cent bond at $100, and that bond is quoted on the market on valuation day at $85, there would not be tax on the redemption or sale of the bond unless the taxpayer receives more than $100. Another taxpayer who purchased a bond of that issue in the market for $80 would be taxed on redemption or sale if he receives more than the $85, unless writing the $20 discount off over the remaining term of the bond would have increased his "amortized cost" to more than $85.

3.30 The government does not wish to force Canadians to compute the "amortized cost" of their present portfolio of bonds where the original discounts were small. Therefore, if a taxpayer had purchased an issue for 95 per cent or more of its face value, he would be exempt from tax on sale or redemption, unless the proceeds exceed the face value of the bond. These transitional arrangements would, of course, only apply to taxpayers who are not at present taxable on the realization of discounts. Bond traders, chartered banks, life insurance companies and others who are now taxable on the realization of discounts would continue to be so.

Shares of Closely-held Canadian Corporations

3.31 The definition of a closely-held Canadian corporation is given in Chapter 4, but it would include most Canadian private corporations. Gains on the sale of shares of these corporations would be fully taxed, and losses on the sale of such shares would be fully deductible (subject to protection against the deduction of personal expenses). This treatment, when coupled with the credit given to Canadian shareholders for the Canadian corporate tax paid by these companies, (see Chapter 4) would produce a balanced system in which there is little if any tax advantage to be secured by a taxpayer through receiving his share of the income of the corporation in the form of gains on the sale of shares rather than dividends, or vice versa. This would remove one of the strongest temptations to tax avoidance in the present act. It would also produce a system in which the weight of tax on private companies is identical to that on the unincorporated businesses with which they compete. This balance is explained more fully in Chapter 4.

Shares of Widely-held Canadian Companies

3.32 The final category of assets for special mention consists of shares in widely-held Canadian companies. Again, this phrase is defined in Chapter 4, but it would include listed Canadian companies and Canadian companies whose shares are traded over the counter.

3.33 Taxpayers other than widely-held Canadian corporations would include only one-half of their gains on the sale of these shares in taxable income and deduct only one-half of their losses. However, they would be required to revalue these shares to market value every five years and take one-half of the resulting gain or loss into account

for tax purposes in that year. A special rate is proposed for widely-held Canadian corporations to avoid double tax. This is explained in Chapter 4.

3.34 The rule that only one-half of gains or losses would be taken into account for tax purposes would put Canadians in approximately the same tax position regarding capital gains and losses on these shares as most of the non-residents who invest in Canada. Specifically, it would put them on approximately the same footing as American individuals and corporations and British individuals and corporations. (It would be impracticable to attempt to tax non-residents on their profits on the sale of small blocks of publicly listed Canadian shares.)

3.35 The 50-per-cent taxability of such gains, coupled with the 50-per-cent credit for corporate tax paid by such corporations, should also result in a relatively balanced system in which there is little incentive for Canadians to receive their income in the form of capital gains rather than dividends, or vice versa. Again this balance is explained more fully in Chapter 4.

3.36 The proposal that the accrued gains or losses on those shares be taken into account every five years is one of two exceptions to the general rule that capital gains and losses would be taxable only when they are realized. (The other exception concerns taxpayers who leave Canada.) Periodic revaluation would reduce somewhat the value of the half-gains rule. It would reflect the fact that these shares are readily marketable and that a taxpayer can, therefore, realize his gain or loss fairly easily at the time of his choosing. The shares of private companies do not have the same marketability.

3.37 Periodic revaluation would also reduce the "lock-in" effect that might well otherwise occur. If a taxpayer faces a tax on the sale of an investment, and that tax is postponed if he holds on to the investment, he may feel "locked in". As long as he holds, he would have, say, $100 working for him. If he sells, he would have only, say, $90 or $95 to reinvest. Since periodic revaluation would reduce this lock-in effect, it would reduce what might otherwise be an obstacle to the workings of the capital market. Revaluation would also make it feasible for the government to classify more corporate reorganizations and mergers as tax-free transactions than would otherwise be the case, thus removing a tax barrier that might otherwise have impeded transactions that are desirable for economic reasons. Finally, it would reduce the tax postponement which would otherwise result from the treatment suggested in paragraph *3.42* to those cases where the lack of marketability of the assets made the treatment compelling.

3.38 The process would not begin until five years after capital gains become taxable. Beginning in the fifth year, individual taxpayers would revalue their holdings of shares of widely-held Canadian corporations in each year in which they attain an age that is divisible by five. Corporations would also revalue their holdings of these shares every five years, likely on the fifth anniversary of incorporation and each other anniversary divisible by five. Dispersing the valuation process through a five-year cycle would reduce the pressure in any particular year—the pressure of the work load on the administration and the pressure that might otherwise develop on market prices every five years. To further disperse this latter pressure, it is proposed that revaluation take place as of the end of the month in which the significant birthday or anniversary takes place.

Deemed Realizations

3.39 The general rule would be that capital gains and losses would be taken into account for tax purposes in the year in which the taxpayer disposes of the asset. Several exceptions are proposed to this rule. Some would result in tax not being due even though the taxpayer has sold the asset. These are explained later under the heading "rollovers". Two would result in a gain being taxed even though the taxpayer has not sold it. In the preceding section of this chapter a procedure was described whereby the gains accruing on shares of widely-held Canadian corporations would be taxed

every five years, whether or not the owner sells the shares.

3.40 The other deemed realization would occur when a taxpayer gives up Canadian residence. The general rule would be that he would be treated as if he had sold all his assets on that day at their fair market value. On the other hand, when a taxpayer moves to Canada he would generally be treated as though he had on that day purchased his assets at their fair market value. The combination of these two rules would mean that Canada would tax only the increase in value that arises during the time that the owner is resident in Canada.

Gifts and Bequests

3.41 Special rules would be required to provide equitable treatment should a person give an asset to someone. The act now contains rules that apply when depreciable property is transferred by gift. Under these rules, the person making the gift is treated as if he had sold the asset for its fair market value and then made a gift of the proceeds. The person receiving the property is treated as if he had purchased the asset for its fair market value. These same rules would apply if other kinds of property are gifted during the lifetime of the donor.

3.42 If the same rules applied when property was transferred on the death of the owner, it is possible that two taxes could apply at the same time—an income tax on the capital gains accrued on assets owned by the deceased, and an estate tax on the property which he leaves. Further, these taxes could apply at a most inconvenient time. To avoid this situation, the government proposes that capital gains not be accrued at the time of death but that the person who inherits the assets be treated as if he had purchased them at their cost to the deceased. This cost would be increased by part of the death taxes paid on the assets in question—the part that relates to the capital gain. In this way, there would not be a capital gains tax unless or until the executor or beneficiary disposes of the asset.

Rollovers

3.43 The government believes that there are some situations in which it would be unfair to collect a capital gains tax even though the taxpayer has sold or otherwise disposed of an asset at a profit. These situations fall into two broad classifications—those where there is a forced realization and those where there has been no change of underlying ownership even though there has been a sale.

3.44 Examples of forced realizations are expropriations and the collection of insurance proceeds or damage claims in connection with the destruction of an asset. In either of these cases, if the taxpayer uses the whole of the proceeds to purchase similar property within a year of the receipt of the proceeds, a gain that would otherwise be taxable would be treated as a reduction in the cost to him of the new property. Therefore, the gain would only be taken into account for tax purposes if and when he disposes of the replacement property. If he should spend less than the full proceeds, any amount that he keeps would be considered to be part of the gain and would be taxable immediately. In that case, of course, that part of the gain would not reduce the cost to him of the replacement property. As explained earlier, this same process would apply where a taxpayer uses the proceeds of sale of one home to buy another home in connection with certain changes of employment.

3.45 The second type of transaction which would qualify for a rollover would almost always involve a corporation. If a taxpayer transfers some of his assets to a corporation in which he owns all of the shares, there is a sale within the legal definition of that word, but there has been no change in the underlying beneficial ownership of the asset. The government proposes that this fact be recognized by treating the transaction as though it had been a sale at the cost to the taxpayer of the property transferred. Tax would be postponed until either the corporation sells the assets or the individual sells his shares in the corporation.

3.46 For example, suppose that a taxpayer owns an apartment building in which his undepreciated capital cost is $300,000 but which has

a market value of $500,000. If the taxpayer transfers this apartment building to a corporation in exchange for the common shares of the corporation, then, assuming he owns all of the shares of the corporation, there would be no taxable gain at the time of the transfer. Rather, the corporation would be treated as having purchased the building for $300,000, and the taxpayer would be treated as having purchased the common shares of the corporation for $300,000. If either subsequently sells its asset, tax would then become due.

3.47 For technical reasons, this rollover must be restricted in three ways. First, it cannot be granted with respect to transfers to foreign corporations, otherwise the gains might slide right through the Canadian tax net untouched. Nor can it be granted with respect to transfers to widely-held Canadian corporations or with respect to transfers of shares of widely-held Canadian corporations. Since gains on the sale of those shares would be only 50-per-cent taxable and losses only 50-per-cent deductible, the provisions necessary to achieve the appropriate ultimate result would be too complex.

3.48 This treatment of transfers would also apply at the time of incorporation of a partnership, provided the partners have exactly the same economic interest after the incorporation as they had before. Generally this would mean that they would have to receive the same proportion of every class of share or claim against the corporation as they previously were entitled to receive of partnership profits and assets.

3.49 Somewhat similar rules would govern on the winding-up of a closely-held Canadian corporation. If there is only one shareholder, the tax treatment would be designed to put the parties in the same position as if, first, the corporation had sold its assets to that shareholder for a price equal to the cost to him of his shares in the corporation, and then the corporation had distributed those proceeds on winding-up. If there is more than one shareholder, the treatment would be similar provided all shareholders have exactly the same economic interest after liquidation as before.

3.50 If a corporation splits its shares without increasing its paid-up capital, it would be a tax-free transaction and each shareholder would spread the cost to him of the old shares over the larger number of new shares. If, however, the corporation includes something else in the transaction—for example, in a reorganization involving common shares it includes debt claims or shares that are not common shares—it is proposed that shareholders be treated as having realized their potential capital gain to the extent of the value of this other asset that they have received. Also, if rights are varied in the reorganization—some shareholders receiving one thing and other shareholders of the same class receiving something else—it is proposed that it be a taxable transaction.

3.51 Most other reorganizations or mergers involve a change in economic interest—a barter. It is proposed that, at least initially, these transactions be treated as taxable realizations if they involve closely-held Canadian corporations or foreign corporations. It may still be possible later to identify more situations in which a rollover can be granted without permitting taxpayers to accomplish tax-free in an indirect manner what would be taxable if done directly.

3.52 Because of periodic valuation, it would be possible to relax this rule with respect to the shares of widely-held Canadian corporations. Tax would be due every five years on the accrued gains on such shares. Since tax postponement is already limited, it is proposed to treat most reorganizations which involve only the shares of widely-held Canadian corporations as non-taxable transactions. For example, if public corporation A offers its common shares for the outstanding common shares of public corporation B, shareholders who accept the offer would not be taxed at that time: they would simply transfer the cost of their B corporation shares to their new A corporation shares. This rollover should mean that this class of reorganization and rationalization can proceed without tax impediments.

Beginning the System

3.53 Paragraph *3.15* sets out the general rule that taxpayers could deduct from the proceeds of

sale of assets the value of those assets on valuation day. If this rule were applied to all assets, some Canadians would be excused from tax under the new system who would have been taxable under the present system. For example, a land speculator who purchases a farm for less than its current value is taxable under the existing system if he sells that farm. It would be perverse if a change that was designed to increase the percentage of the income of the wealthy that is brought to tax should in this particular instance create an exemption for the speculator. The law would be drafted in such a way as to make sure this does not happen.

3.54 Another example concerns taxpayers who own depreciable property that they are using for income-earning purposes. Consider the case of a taxpayer who bought an apartment building for $500,000 and has over the years claimed depreciation for tax purposes of $200,000. Under the present system if he sells the apartment building for more than $300,000, the next $200,000 is treated as a "recapture" of the depreciation he has been permitted and either directly or indirectly comes into the computation of his taxable income. Only if he sells the building for more than $500,000 will any part of the proceeds be considered a capital gain—the excess over $500,000. The act would be drawn up in such a way as to make it clear that the taxpayer is still liable for tax on recaptured depreciation.

Yields from the Tax

3.55 The lack of Canadian experience with a capital gains tax system means that it is impossible to develop precise estimates of possible yields. However, we anticipate that after it has "matured", the proposed system would produce several hundreds of millions of dollars annually. The United States tax on capital gains raises between 5½ per cent and 7 per cent of the total United States personal income tax. While there are significant differences between the United States system and these proposals, we estimate that the taxation of capital gains could ultimately produce more than 5 per cent of total Canadian personal income tax: 5 per cent of the estimated current yield of the income tax is approximately $390 million.

3.56 However, the yield from the tax would build up only gradually. For one thing, gains subject to tax would be limited to those gains that accrue following valuation day. In addition, since most gains and losses would be taken into account only when realized during the first four to eight years, there would be a natural tendency for people to take their losses earlier than usual in order to obtain the tax saving, and realize their gains later than usual in order to postpone the tax liability. All in all, we estimate that the period of build-up would take between seven and ten years.

4

Corporations and their Shareholders

4.1 About 200,000 corporations file Canadian income tax returns. These corporations vary greatly in size; some are among the largest in the world, others the incorporation of a one-man enterprise. The large corporations may well have thousands of shareholders; the one-man business often will have only one shareholder (or one owning almost all of the shares and others with a nominal interest if the Corporations Act requires that a corporation have more than one shareholder).

4.2 The relationship between corporation and shareholder also differs substantially from corporation to corporation. A shareholder who owns a substantial proportion of the corporation's shares will usually take an active part in its affairs. Indeed, he will often work full-time or part-time for it. His asset is a share certificate representing claims on the corporation; for example, the right to receive the same dividend per share as others who own the same type of share, or to receive the same amount per share as those others if the corporation is wound up. However, in his mind he is part owner of all of the corporation's assets and operations.

4.3 On the other hand, if the shareholder is only one of thousands—often the case if shares are listed on a stock exchange—his relations with the corporation are likely to be very formal. The annual meeting is his only opportunity to take part in corporation decisions, and he usually does not go. Not only is his asset a share certificate in the legal sense, that is how he thinks of the situation. But in the case of a mutual fund the shareholder may well consider that he is a part owner of the portfolio of the mutual fund even though there are thousands of other shareholders in the fund.

4.4 It is little wonder that it has always been difficult to design a tax system that can be applied appropriately to all of these different types of corporations and corporate relationships.

The Present System

4.5 Canada has levied a tax on the incomes of corporations since 1917. For the first 20-odd years—until the war—this tax was lower than the top rates of personal income tax and a further personal income tax was due if and when the corporation profits were distributed to individual shareholders.

4.6 Such a system has certain inevitable consequences, which can best be explained by considering the case of a corporation owned by one individual:

(1) The total tax paid on income received by the corporation and then passed on to the individual as a dividend is greater than the tax paid if the income was re-

ceived directly by the individual (for example, if the corporation tax rate was 30 per cent and the personal tax rate 50 per cent, the tax would be $50 if $100 of income was received directly, compared with a total tax of $65 if the $100 was passed through the corporation —$30 corporate tax, leaving $70 for dividends, on which the personal tax would be $35);

(2) However, the tax that must be paid immediately—the corporate tax—may well be less than if the individual received the income directly, and the balance of the tax need not be paid unless or until the profits are passed on to the individual (in the example mentioned above the corporate tax was only $30, whereas the personal tax would have been $50);

(3) If the profits can be left in the corporation long enough, having the use of the tax savings and the ability to invest at higher after-tax rates of return can more that offset the extra tax paid as a result of using the corporation;

(4) The longer profits are left in the corporation, the more the shareholder considers them as his own and the more he resents having to pay a further tax to transfer them from his corporation to himself (and the longer the profits are in the corporation, the more time he has to try to devise ways of making the transfer tax-free); and

(5) If several years' profits are drawn out in one year, the result may well be that a substantial part of the dividend is pushed into a tax bracket with a rate considerably higher than the shareholder's usual marginal rate (and substantial amounts may be required from time to time by the shareholder to meet personal financial needs).

4.7 There is little likelihood of the shareholder of a public corporation feeling that he owns the assets of the corporation, and little likelihood of the corporation paying out several years' earnings in one year. Further, the shareholder in a public corporation is to a considerable extent unaware of the operation of the interaction of the personal and corporate tax rates: he considers that his income from his shares is his dividend (plus the gain on the sale of the shares, or minus the loss). As a result, most of the pressure for change in the corporate tax system during the first 25 years centred on closely-held corporations. In particular, it grew out of the problem created by many years' profits accumulated in the corporation, and the abnormally large tax due if they were withdrawn—to pay estate taxes or succession duties, for example.

4.8 Special opportunities were given to corporations to distribute profits accumulated up to 1930 and 1939, respectively. In the former case the distribution was free of tax. In the latter case it was taxed at rates ranging from 15 per cent to 33 per cent.

4.9 During the war of 1939-45 all tax rates were dramatically increased, including the rates on corporation profits. In the years immediately following the war, there were reductions, but the resulting rate—30 per cent in 1947 and 1948—still was heavy enough to produce anomalies and strain. This time, the pressure for change related not only to the problem of the abnormally high tax collected on large distributions, but also to the fact that two taxes were collected on profits flowing through small corporations and that this put them at a disadvantage relative to the unincorporated businesses with which they competed.

4.10 In an attempt to solve this problem, two important changes were made in the tax system in 1949. First, a two-rate system was introduced for corporations. The first $10,000 of income annually was to be taxed at 10 per cent and any income over $10,000 was to be taxed at 33 per cent. This produced a substantial reduction in tax for small corporations, but little reduction, or an increase, for large corporations.

4.11 The second change was to introduce the dividend tax credit. An individual resident in

Canada who received a dividend from a "taxable Canadian corporation" was allowed to deduct 10 per cent of the dividend from his income tax. For shareholders of small corporations, this credit was intended to offset the 10-per-cent corporate tax paid by the corporation. For shareholders of larger corporations, the credit would offset part of the Canadian corporate tax paid and serve as an incentive to Canadians to invest in Canadian corporations.

4.12 The rates of corporate tax, the amount of income to which the lower corporate rate applies, and the rate of dividend tax credit all have changed since 1949, but the basic system remains unchanged. Leaving aside the 3 per cent surtax which ends in 1970, the corporate rates in the federal act are at present 21 per cent on the first $35,000 of income annually, and 50 per cent on the excess. The total federal and provincial corporation taxes are higher in those provinces that have a rate higher than 10 per cent (the federal government reduces or "abates" its rates by 10 percentage points to make room for a provincial corporation tax). Meanwhile the rate of dividend tax credit has increased to 20 per cent.

4.13 The dividend tax credit is a rough and ready method of offsetting corporate tax. Although it applies only to dividends from "taxable Canadian corporations", it does not follow that the corporation has in fact paid Canadian corporation tax, or enough of it to cover its dividends. The only dividends from corporations incorporated in Canada that do not qualify are those from corporations which are classified as non-taxable. If a corporation is paying dividends from foreign profits or from Canadian profits that have not been taxed by Canada for one reason or another, the dividends still qualify.

4.14 Because an individual cannot get a refund if the dividend tax credit exceeds his tax liability, the credit is of no help to shareholders whose incomes are below the exemption level. Because it is a tax-free amount, the credit is worth more to high-rate taxpayers than it is to low-rate taxpayers. This effect is illustrated in the following table:

	Marginal Rate of the Taxpayer			
	0%	20%	50%	80%
Dividend received	$100	$100	$100	$100
Gross tax	0	20	50	80
Less dividend tax credit	0	20	20	20
	0	0	30	60
After-tax dividend	$100	$100	$ 70	$ 40
Ordinary income required to produce this after-tax amount	$100	$125	$140	$200

4.15 While these post-war changes relieved the pressures in some instances, new pressures developed and some of the old problems remained. The low rate of tax made it possible for taxpayers who incorporated their business or their investment portfolio to reduce their tax rate on $35,000 of income annually to 21 per cent. This gave them a significant advantage over those persons with similar incomes who did not or could not incorporate their business or their investment portfolio, because the marginal rate of personal tax on an income of $35,000 is 50 per cent. If the taxpayer who had incorporated his business wished to draw the funds out, there could be a substantial additional personal tax to pay. This tax would normally not be more than the amount necessary to provide parity with his unincorporated competitor—and could be less—but naturally the shareholder was not eager to pay it. Consequently he postponed the day for as long as possible and often it was postponed until some personal financial crisis made it necessary to withdraw very large amounts.

4.16 Some taxpayers were not content with obtaining only $35,000 at the low rate annually. By incorporating several companies they sought to multiply this amount several times over. Given the almost infinite flexibility in the share structures of corporations, it was possible for some to keep one step ahead of every change in the law designed to restrict taxpayers to one amount of $35,000 annually. Shareholders also developed sophisticated schemes to obtain the profits from their corporation

without paying personal tax. Many of these schemes involved a sale of the shares of the corporation for a tax-free "capital gain", although other steps in the scheme resulted in the shareholders still controlling the business.

4.17 Finally, in 1963 Parliament gave the Minister of National Revenue discretion to specify that any two or more companies were "associated" and therefore entitled only to one $35,000 amount between or among them. It also gave him discretion to look through various types of schemes and tax shareholders as though they had received income from the corporation regardless of the legal form of their transactions.

4.18 The present situation therefore has several shortcomings:

(1) Only part of the total tax due on the earnings of corporations is collected at the time that the earnings arise. (21 per cent is collected from small corporations immediately, and the shareholder's personal tax is collected only when the profits are distributed by the company to the shareholders.)

(2) This delay in collecting the second instalment of tax gives shareholders—particularly shareholders of closely-held companies—time to grow accustomed to having the assets represented by the profits under their control, time to consider them as being their own. As a result, their resentment on payment of the second instalment of tax increases.

(3) Also as a result of the delay they have time and reason to search for ways of avoiding the second tax.

(4) Because of the low rate, a taxpayer whose business can be incorporated can earn up to $40,000 at marginal rates of 21 per cent or less, but a taxpayer who cannot incorporate his source of income can earn only $5,000 before his marginal rate exceeds 21 per cent.

(5) By using a corporation, some taxpayers can ensure that none of their income need be exposed to the rates in excess of 50 per cent unless or until they need to withdraw the money from the company for personal use.

(6) The dividend tax credit is of significantly greater value to high-income taxpayers than it is to low-income taxpayers.

(7) The dividend tax credit is granted to shareholders of a Canadian company whether or not the company has paid enough Canadian corporate tax to cover the credit—indeed even if the company has not paid any Canadian corporate tax at all.

The Proposal

4.19 The government's proposal is to create one set of rules for the closely-held corporation—the incorporated proprietorship or partnership—and another set of rules for the widely-held, public corporation. This distinction reflects the difference in the relationship between the two types of corporations and their respective shareholders. It also reflects the fact that, by and large, the closely-held corporation competes with proprietorships, partnerships and of course with other closely-held corporations, while the public corporation competes with other public corporations, both Canadian and foreign.

Closely-held Corporations

4.20 The objective of the proposals for closely-held corporations is to put them as nearly as possible in the same tax position as their competitors. In other words, to design a system that will produce the same tax on a Canadian whether he carries on his business in his own name or whether he incorporates it.

4.21 This objective will best be achieved in those instances in which the corporation can elect to be taxed as a partnership. Under this option, the corporation would not pay any corporation tax at all, but each shareholder would pay personal tax each year on his share of the corporation's profits.

4.22 If this rule were applied to all closely-held corporations, there would be instances in

which shareholders who own a few shares in the corporation would be forced to pay tax when they do not receive any income from the corporation, and have no means at their disposal to force the corporation to declare dividends to provide cash with which to pay the tax. Consequently it is proposed that this "partnership option" be available only in those instances in which all shareholders sign an election that the corporation's profits be taxed in this manner.

4.23 For technical reasons, three restrictions must be imposed on corporations that can be treated as partnerships. First, it must be clear what portion of the profits each shareholder is going to receive. This would usually mean that the corporation can have only one class of shares, although there may be instances in which the respective rights of different classes of shareholders would be unchanged by differing future circumstances, including winding up the corporation. Secondly, all shareholders must be individuals resident in Canada or corporations incorporated in Canada. If the profits are to be taxed according to the circumstances of the shareholder, the government must be able to determine what those circumstances are, and whether the person in whose name the shares are registered is in fact the owner of the shares and not a nominee. Finally, if some shares are held by Canadian corporations, those corporations must have the same fiscal year-end as the corporation itself. In the absence of this year-end rule, it would be possible to postpone tax for several years by using a chain of corporations with appropriate year-ends.

4.24 In the case of those corporations which are not to be treated as partnerships, parity with the shareholders of partnership corporations would be achieved in two steps. There would be a tax of 50 per cent on the taxable income of the corporation. However, when the net profits are distributed to the shareholders, credit would be given for the full amount of the tax paid by the corporation on those profits.

4.25 An example may help to explain how this system would work. A closely-held corporation with profits of $20,000 would pay a tax of $10,000, leaving $10,000 to be distributed to the shareholders. When the corporation pays the next $10,000 in dividends, it would instruct the shareholders to report $20,000 as their income for tax purposes (the before-tax profit of the corporation) and to claim credit for the $10,000 of tax paid by the corporation. A shareholder who receives a dividend of $100 would therefore report $200 as his income from the corporation and would show on his return that $100 tax had been paid by the corporation. If his marginal tax rate is 40 per cent, the tax on the dividend would be $80 and he would be entitled to a refund from the government of the extra $20. In this way the ultimate tax on his share of the profits of the corporation would be the same as if he had received the $200 directly.

4.26 This procedure of giving credit to the shareholder for taxes paid by the corporation would be applied both to cash dividends and to stock dividends, so that the process should not by itself force private corporations to pay out in cash a higher proportion of their profits than they would under the present system. In the case of a stock dividend, the shareholder would of course not have received any cash from the corporation with which to pay his tax. However, the credit he receives for the tax paid by the corporation would cover his liability on the dividend unless his marginal tax rate exceeds 50 per cent. Therefore the system would not result in taxpayers being forced to pay tax at a time when they lack means to satisfy the tax liability.

4.27 For the shareholder to receive credit for tax paid by a corporation, the corporation would have to pay the appropriate dividends—either cash or stock—within a limited period of time. It is proposed that tax paid with respect to a given taxation year should be creditable only if it is passed through to the shareholders within 2½ years from the end of the corporation's taxation year. This is necessary in order to limit the amount of outstanding claims against the government: if corporations accumulated creditable tax for 10 or 15 years, large dividends at the end of that time could seriously affect government revenues in the year of distribution. Further, the rule would limit the amount of creditable tax in any given corporation at any given time and so reduce the temptation to taxpayers who

cannot make use of creditable tax to "sell" it to taxpayers who can make use of it.

4.28 The government believes this is a fairer way of dealing with the income of Canadians flowing through closely-held corporations. In effect, the present system gives an arbitrary concession to small corporations. The proposed system would graduate the tax according to the circumstances of the shareholder. Therefore the benefit would go to shareholders with small incomes rather than to corporations with small incomes.

4.29 While the government believes this system is much fairer than the present one, it must be acknowledged that it would substantially increase the taxes to be borne by existing small corporations, and many of these corporations may have made financial commitments based upon the present tax system and the after-tax income they can expect under the system.

4.30 It is therefore proposed that the low rate be removed from the business profits of small corporations gradually over a period of five years. For corporations with taxable business profits not greater than $35,000 the low rate would apply to $28,000 in the first year of transition, $21,000 in the second, $14,000 in the third, $7,000 in the fourth, and be eliminated entirely in the fifth year. For corporations with taxable business profits above $35,000, the amount subject to the low rate would be reduced more quickly the more the corporation's taxable profits exceed $35,000. The benefit would be removed immediately if taxable business profits equal or exceed $105,000. In other words, the larger the corporation the more quickly it would lose the benefit designed for small corporations.

4.31 The precise formula would remove 80 cents of a corporation's entitlement to be taxed at the low rate for each $2 of business income in excess of $35,000 in the first year of transition. In the second year the reduction would be 60 cents for each $2; in the third year, 40 cents for each $2; and in the fourth year, 20 cents for each $2. In the meantime the maximum entitlement would be reduced, so that the effect would be a gradual reduction in the amounts subject to the low rate of tax. For example, a company with taxable business profits of $85,000 in each of the first five years of the new system would be entitled to have $8,000 taxed at the low rate in the first year, $6,000 in the second year, $4,000 in the third year, $2,000 in the fourth year and nothing the fifth year. On the other hand, a corporation that earns $45,000 in each of the first five years would be entitled to have $24,000, $18,000, $12,000, $6,000 and zero taxed at the low rates.

4.32 Taken together these proposals concerning closely-held corporations should provide a tax system with the same effect on business carried out through such a corporation as on business carried on through a proprietorship. It should also collect the same tax on the investment income of a Canadian individual whether he holds his investments directly, or whether he holds them through a personal holding corporation.

4.33 Meanwhile gains realized on the sale of shares in closely-held corporations would be taxed as ordinary income, and losses suffered on the sale of such shares would be deductible from other income for tax purposes. When coupled with the system of full integration, this would mean that the tax effects would be the same whether an individual causes his corporation to sell its assets to a prospective purchaser or chooses to sell his shares to that purchaser, thereby giving the purchaser indirect control of the assets.

Widely-held Corporations

4.34 By and large, a Canadian widely-held public corporation competes with other public corporations. In this league it is natural for the competition to bear a corporation income tax and we consider it likely that some level of corporation tax is passed on to customers in the price which the corporations charge for their goods and services.

4.35 At present United States corporations bear tax at 52.8 per cent and United Kingdom corporations at 45 per cent. Against this background

a Canadian corporation tax of 50 per cent seems reasonable and competitive. For this reason the government does not propose to give Canadian shareholders of such corporations full credit for the corporation tax paid by those corporations.

4.36 However, the government does want to reform the dividend tax credit. It proposes to replace the existing credit with a system giving Canadian shareholders credit for one-half the Canadian corporation tax paid by the corporation on the profits from which the dividend is paid.

4.37 Again, an example may help to explain how the system would work. A Canadian public corporation with profits of $1,000,000 would pay a tax of $500,000, leaving $500,000 available for distribution to the shareholders. If it pays the $500,000 out in dividends, it would instruct the shareholders to report $750,000 as their income for tax purposes and to claim credit for $250,000 of the $500,000 of corporate tax paid by the corporation. A shareholder who receives a dividend of $100 would therefore report $150 as the income from the corporation and would show on his return that $50 tax had been paid by the corporation, $40 federal and $10 provincial. If his marginal tax rate is 40 per cent, the tax on the dividend would be $60 and he would owe the governments $10. If his marginal tax rate is less than one-third he would be entitled to a refund. As in the case of closely-held corporations, this procedure would be applied both to cash dividends and to stock dividends so that the process should not by itself force corporations to pay out in cash a higher porportion of their profits than they would under the present system. Also, as in the case of closely-held corporations, the credit would only be given if the corporation declares these dividends within the time limits prescribed.

4.38 The government believes this way of providing an incentive to Canadians to purchase shares in Canadian corporations is fairer than the dividend tax credit. It would give all Canadian individuals credit for the same amount of corporate tax on any given dividend. This is illustrated in the following table:

	Marginal Rate of the Taxpayer			
	0%	30%	50%	70%
Dividend received	$100	$100	$100	$100
Plus taxable credit	50	50	50	50
Taxable amount	$150	$150	$150	$150
Gross tax	$ 0	$ 45	$ 75	$105
Less credit	50	50	50	50
Net tax (refund)	$ (50)	$ (5)	$ 25	$ 55
Amount retained	$150	$105	$ 75	$ 45
Amount of ordinary income necessary to produce this amount	$150	$150	$150	$150
Corporation tax "offset"	$ 50	$ 50	$ 50	$ 50

4.39 It would also mean that credit is given only for taxes actually paid to Canada so that the incentive would be limited to a forgiveness of tax and would not involve a net payment from the Canadian treasury.

4.40 While credit would not be given for foreign corporation taxes paid, it is proposed that corporations receiving income from other countries be enabled to pass through to their shareholders credit for 15 percentage points of withholding tax levied by those foreign countries on the income received. This would provide neutrality between those taxpayers who receive foreign investment income directly and those other taxpayers who receive it through a Canadian corporation. It would also, to a substantial extent, offset the loss of the dividend tax credit for shareholders of those corporations. This provision is explained in more detail in Chapter 6.

4.41 This system of partial credit also produces a rough balance when combined with the proposal

that gains or losses on the sale of shares in Canadian widely-held corporations be taken into account only to the extent of 50 per cent in computing taxable income. This balance is not precise. It is almost exact in the case of upper-income taxpayers, those most likely to be able to arrange their affairs to receive their income in the form that reduces taxes to a minimum. It is less balanced in the case of taxpayers in lower rate brackets. They would be better off to receive their income in dividends than in the form of capital gains. This probably coincides with their natural inclination to buy into well-established Canadian corporations where their investment is less at risk. This effect is illustrated in the following table:

	30% taxpayer		*50% taxpayer*	
	Capital gain	*Dividend*	*Capital gain*	*Dividend*
Amount in question	$100	$100	$100	$100
Plus taxable credit		50		50
Less one-half gain	50		50	
Taxable amount	$ 50	$150	$ 50	$150
Tax	$ 15	$ 45	$ 25	$ 75
Less credit		50		50
Net tax (refund)	$ 15	$ (5)	$ 25	$ 25
After-tax income	$ 85	$105	$ 75	$ 75

4.42 As mentioned above and in Chapter 3, the government proposes that half of the gain on the disposal of a share of a Canadian public corporation be taken into account in computing taxable income. This lower rate of tax on the gain would complement the partial credit given for corporate tax and provide the other half of the government's incentive to Canadians to invest in Canadian corporations. To forestall a fairly straightforward tax-avoidance technique, it would be necessary to grant deduction for only half of the loss on the sale of such a share.

Closely-held v. Widely-held

4.43 These proposals obviously put considerable importance on the distinction to be drawn between closely-held Canadian corporations and widely-held Canadian corporations. The rules proposed for defining a widely-held corporation are as follows:

(1) All corporations with shares listed on a prescribed Canadian stock exchange on the day the White Paper is published would be deemed to be widely-held corporations.

(2) All corporations which subsequently list their shares on these exchanges would become widely-held corporations on the day on which their shares are so listed.

(3) Corporations which can meet specified tests concerning the number of shareholders and the number of shares held by those shareholders could elect to be classified as widely-held corporations.

(4) The Minister of National Revenue would have the power to designate other corporations as widely-held corporations if they meet certain tests relating to number of shareholders, dispersal of shares and public trading in shares. (In practice this would mean that most corporations with shares traded "over the counter" would be classified as widely-held corporations.)

(5) Once a corporation is classified as a widely-held corporation it would always remain a widely-held corporation.

Only corporations incorporated in Canada would be eligible to be treated as Canadian widely-held corporations.

4.44 From the time a corporation becomes a widely-held corporation shareholders would receive

credit for only half the tax paid by the corporation. Any creditable tax on hand at the time of transition would effectively be cut in half.

4.45 Proceeds from the sale of a share of such a corporation after it becomes a widely-held corporation would be taken into income for tax purposes to the extent of 50 per cent, even though part of the increase in value may well have occurred while the corporation was a closely-held corporation. This provision reflects the expectation that closely-held corporations would distribute—either by cash dividend or stock dividend—almost all of their profits to their shareholders, and that the accruing capital gain, if any, on such shares would therefore relate almost entirely to the expectation that the corporation would be able to earn greater profits in future. Because the shareholders would receive credit for only half of the corporation tax paid on these future profits, it is reasonable that the government collect tax only at half rates on the sale of those future profits.

Canadian Shareholders of Foreign Corporations

4.46 The government does not propose to give individuals who hold shares in foreign corporations credit for the corporate tax paid by those corporations. For the most part, the investment that a Canadian can make in a foreign corporation will be in a public corporation or in a corporation large enough to compete with public corporations. Therefore the pricing and profit structure of the corporation will contemplate the payment of a corporation tax. And of course the government has no desire to provide an incentive to Canadians to invest in foreign corporations: it does not intend to put barriers in the way of their doing so but it does not want to provide a tax incentive to induce them to do so. Further, most foreign countries have a corporation tax which is separate from the personal income tax and do not give a credit to shareholders in respect of the corporation tax paid by the corporation. If Canada were to give a credit for the corporation tax paid in that country, it would be giving Canadians an advantage over the residents of the country in the business enterprises of that country. Finally, it is one thing to forgo taxes to accomplish a given purpose. This is what is being done with respect to Canadian shareholders of Canadian corporations. It is a quite different thing to make payments to people in respect of taxes paid to other countries: this would represent a net drain on the Canadian treasury.

4.47 The government does not propose to give Canadian corporations which have a portfolio investment in foreign corporations credit for the tax paid by those corporations on the profits out of which they pay their dividends. These corporations stand in the same relationship to these foreign corporations as does the individual Canadian shareholder to the widely-held Canadian corporation in which he invests, and the government does not wish to provide a tax incentive to Canadian corporations to make portfolio investments abroad. As previously mentioned, it does propose to provide Canadian corporations with a mechanism by which they can pass through to their shareholders the withholding tax that they suffer on dividends received from foreign investments. This provision, which would provide neutrality with individuals who hold their foreign investments directly, is described in more detail in Chapter 6.

4.48 The government does propose, however, to grant to Canadian corporations which have a controlling interest in foreign corporations, credit for the corporation taxes paid by those foreign corporations. These Canadian corporations stand in the same relationship to their foreign controlled corporations as does the Canadian individual shareholder to the closely-held Canadian corporation in which he has an interest. Again, this proposal is outlined in greater detail in Chapter 6.

Foreign Shareholders of Canadian Corporations

4.49 The government does not propose to give foreign shareholders of Canadian corporations credit for the tax paid by those corporations. The principal reason for this decision is that the credit to Canadians in respect of corporations that compete in the international area would be given as an incentive to induce Canadians to purchase shares in these corporations. While the government

welcomes foreign investment in Canadian corporations, it does not believe it is necessary to subsidize non-residents through the tax system in order to induce them to invest their capital in Canada. Canadian resources, labor and management can compete on even terms for capital with their counterparts in other countries. Because the general tax rule in other countries does not include a credit to the shareholder in respect of taxes paid by the corporation, it is not necessary for Canada to enact such a provision, and it would be quite expensive to do so; an expense that would have to be borne by the Canadian taxpayers.

4.50 Moreover, in many instances Canada would not obtain any additional foreign capital as a result of a provision of this sort. Much of the investment in Canada is made by foreign corporations which already receive a full credit against the tax in their home country for Canadian taxes. If Canada were to reduce its net tax on the Canadian subsidiaries of those foreign corporations, the benefit would accrue to the foreign government rather than to the parent corporation. As a result there would be little reason to expect an increased investment by these corporations in Canada.

Intercorporate Holdings

4.51 This chapter has so far dealt with corporations in the context of their relationship with individual shareholders. There are, however, many situations in which shares of one corporation are owned by another. These situations range from cases in which one corporation owns the other completely to cases in which one corporation owns only a few shares in the second.

4.52 Under the present law, dividends received by one Canadian corporation from another taxable Canadian corporation are not taxed. If this exemption were not in the law, corporation tax could be collected twice, three times or even more often from the same profits before they are ultimately distributed to individual shareholders.

4.53 However, the exemption does give rise to two problems under the existing law. The first is that it would, in the absence of special provisions, have permitted Canadians to transfer their shares in public Canadian corporations to a corporation which they control. In this way, they could have postponed until the time of their choice all personal taxes normally due when the dividend from the public corporation came under their control. An attempt has been made to close this loophole by defining a type of corporation—referred to as a personal corporation—the income of which is taxed against the shareholders whether or not it is distributed. However, in practice the definition has been unsatisfactory. It has also been difficult to define satisfactory rules for allocating income to the shareholders in situations where the corporation has a complicated share structure.

4.54 The second problem with the dividend exemption arises from its relationship to other provisions in the act which exempt dividends received by Canadian corporations from certain foreign corporations and from certain "foreign business corporations". Taken together, these provisions make the dividend tax credit available to shareholders of corporations even though the profits are either entirely or almost entirely earned abroad and have not been subjected to Canadian corporate tax.

4.55 The government proposes to restrict the credit to shareholders of Canadian corporations by reference to the Canadian corporate tax actually paid by their corporations. To do this the government must have a more exact method of passing credit for Canadian corporate tax through a chain of corporations. Moreover, the decision to tax capital gains on disposal of shares requires that a more precise method be found for giving credit for corporate tax. Otherwise corporate shareholders could choose to receive tax-free dividends and then to sell their shares, thereby avoiding entirely the tax which would otherwise have been levied on the gain realized on the sale of their shares.

4.56 A closely-held Canadian corporation would be treated in exactly the same manner as would an individual shareholder in receiving credit for corporate tax. Specifically, it would take into its taxable income both the dividend and the taxable credit, and would claim the creditable tax as a de-

duction against the corporate tax which it would otherwise pay. The following table illustrates how this system would work.

Dividend received:		
From another closely-held Canadian corporation	$100	
From a widely-held Canadian corporation		$100
Plus taxable credit	100	50
Taxable amount	200	150
Gross tax	100	75
Less credit	100	50
Net tax	0	25
Amount available for distribution to its shareholders (dividend minus net tax)	100	75
Creditable tax available (gross tax amount)	$100	$ 75

4.57 A widely-held Canadian corporation receiving a dividend from a closely-held Canadian corporation would be taxed on the dividend in the same way that it is taxed on other income. Specifically, the corporation receiving a dividend of $100 from a closely-held Canadian corporation would take into its income for tax purposes $200 and claim as a deduction from the corporate tax it would otherwise pay the $100 corporation tax paid by the first corporation. In effect the dividend would have been received tax-free in this situation. However, if the corporation that pays the dividend has not paid sufficient corporation tax to Canadian governments to cover the dividend, the receiving corporation would have some net tax to pay.

4.58 When the receiving corporation pays a dividend to its shareholders it would instruct them to add to the dividend for purposes of the tax calculation only half of the corporation tax levied on it. The schedule set out below illustrates this procedure. The effect is that shareholders of Canadian public corporations receive credit for half, and only for half, of the corporation tax paid on the profits from which their corporation pays its dividends. This is true whether the profits are earned in a subsidiary corporation or in the public corporation itself.

Dividend received	$100	$100
Plus taxable credit:		
Assuming the payor corporation had enough creditable tax	100	
Assuming that it did not have enough, say 4/5ths		80
Taxable amount	200	180
Gross tax	100	90
Less credit	100	80
Net tax	0	10
Amount available for distribution to its shareholders (dividend minus net tax)	100	90
Creditable tax available (half of gross tax amount)	$ 50	$ 45

4.59 Special rules are needed to cover the case of a public corporation which receives a dividend from another public corporation. If the dividend were taxable at normal corporate rates, the effect would be to collect more corporate tax in those instances where there are intercorporate holdings than in those instances where the individual shareholder holds his share in the operating corporation in his own name. To overcome this shortcoming it is proposed that a special tax rate be applied to the dividends received by Canadian public corporations from other Canadian public corporations. The rate would be 33⅓ per cent so that this type of intercorporate dividend would be tax-free provided the corporation paying the dividend had paid sufficient Canadian corporate tax to cover the dividend. This special rate would also be applied to capital gains realized by one Canadian public corporation on the sale of shares in another Canadian public corporation. Finally, the loss suffered by one Canadian public corporation on the sale of a share in another Canadian public corporation would reduce tax only at this special rate. The effect of this rate on

dividends passing through an intercorporate chain is illustrated in the following schedule:

	Corporate Chain	*Direct Ownership*
Dividend paid by public corporation No. 1	$100	$100
Public corporation No. 2		
Dividend received	100	
Plus taxable credit	50	
Taxable amount	150	
Gross tax, at $33\frac{1}{3}\%$	50	
Less credit	50	
Net tax	0	
Amount available for distribution	100	
Creditable tax (gross tax amount)	$ 50	
Individual shareholder		
Dividend received	$100	$100
Taxable credit	$ 50	$ 50

Shares held by Pension Funds and other Tax-free Entities

4.60 The government does not propose a refund to pension plans and other tax-free entities of the corporate tax paid by the corporations from which they receive their dividends. It considers that tax-free status of the investment income of the pension plan, including capital gains, is sufficient tax concession to these entities.

Shares held by Mutual Funds

4.61 Open-end mutual funds and most closed-end mutual funds would be widely-held corporations under the definitions proposed earlier in this chapter. As a result shareholders would receive the dividends that flow through the mutual fund subject to the same tax as if they had received the dividends directly. There is one exception to this, in the case of dividends from a closely-held corporation that are routed through a mutual fund. In this instance the government feels it appropriate to levy the same taxes on this portion of the corporate income as if the earnings had been in a public corporation. The relationship of the shareholder of the mutual fund to his corporation is much the same as that of shareholders of other public corporations to their corporations.

4.62 A special rule would, however, be required for mutual funds. This type of corporation must be able to put its shareholders in the same position as if they themselves had realized their proportion of the capital gains of the mutual fund arising on the sale of shares in public Canadian corporations. In the absence of a special provision mutual fund shareholders would pay tax on the full amount of such gains when they were distributed to them, whereas tax should be applied only to half of the gain. Consequently this type of corporation would be enabled to make special distributions to its shareholders which would be treated as though they were a capital gain on the sale of a Canadian public corporation. The effect of this proposal is illustrated below:

	Mutual Fund	*Individual Shareholder*
Gain on sale of shares	$300	$300
Tax:		
At $33\frac{1}{3}\%$ on the gain	100	
At say 40% on one-half of the gain		60
Net gain	200	
Special dividend distributed to shareholders	200	
Taxable credit	100	
Taxable amount	300	
Gross tax, at 40% on one-half	60	
Less credit	100	
Refund	40	
Net amount retained		
Dividend plus refund	$240	
Gain less tax		$240

Electric, Gas or Steam Utilities

4.63 In 1966, Parliament passed the Public Utilities Income Tax Transfer Act under which the Minister of Finance turns over to the provincial governments 95 per cent of the corporation tax collected from certain electric, steam and gas utility corporations.

4.64 The whole scheme of the present proposals contemplates that shareholders of Canadian corporations receive a credit from the federal government for part or all of the federal corporation tax paid by their corporation. It would be contrary to this general scheme if the federal government gave to shareholders of these utility corporations credit for taxes which the federal government has turned over to the provincial governments, and it does not propose to do so.

4.65 It would be possible to give the shareholders credit for the taxes which the federal government retains. However, the amounts would be very small and the government considers it more efficient to ask Parliament to amend the Public Utilities Income Tax Transfer Act so that all of these taxes are turned over to the provinces, who could then decide to what extent they should be turned over to the corporation or its shareholders.

Foreign Corporations Operating in Canada

4.66 The present dividend tax credit applies to dividends received from taxable Canadian corporations. This phrase can cover all corporations resident in Canada whether or not they are incorporated under Canadian laws. As part of its program to improve the effectiveness of the tax system, the government proposes to remove some of the distinctions now made between corporations on the basis of residence and to distinguish instead on the basis of the place of incorporation. (It is possible for foreign corporations to move out of Canadian jurisdiction entirely. This type of manoeuvre is not open to corporations created under Canadian law.) Under the new proposals, the system of credits for corporate tax would apply only to corporations incorporated in Canada.

4.67 This provision could mean a substantial change to some foreign corporations which now are resident in Canada and whose dividends now qualify for the dividend tax credit. Consequently it is proposed that dividends from these corporations be treated the same as dividends from Canadian corporations for a temporary period of five years in order to give them time to rearrange their affairs to conform with the new tax laws.

Co-operatives

4.68 Two rules in the act have a special significance for co-operatives. One provides that a co-operative shall be exempt from income tax for the first three years of its existence. It is proposed that this exemption be withdrawn. If the rules that govern the tax position of co-operatives in the fourth and subsequent years are fair, they should apply to the first three years as well.

4.69 The second rule provides that patronage dividends are deductible in computing the taxable income of the co-operative, subject to a limit. Patronage dividends are deductible before interest paid (other than interest to a bank or credit union) and cannot reduce profits at that point in the computation below 3 per cent of capital employed. This might be thought to ensure that members are taxed on some return on their investment in the co-operative. However, the 3 per cent is far too low in current circumstances. Further, because such other debts as mortgages are taken into account in determining the capital employed, the effective interest taxed to members can be even lower than 3 per cent. (A $200,000 mortgage at an interest rate of 7½ per cent would result in no taxable return on members' investment of $300,000.)

4.70 The government proposes that the interest rate be set in accordance with a formula comparable to the formula used to determine the rate on farm improvement loans—that is, the rate

would vary from year to year depending upon the interest rates paid on government bonds. It is also proposed that only interest paid to members on their loans and capital be taken into account after the deduction of patronage dividends.

4.71 As a result, co-operatives could continue to eliminate taxable income by a combination of patronage dividends and interest to members. However, members would be taxable on a full commercial rate of interest on the investment which they have in the co-operative (provided of course the co-operative earns that much before patronage dividends).

Caisse Populaires and Credit Unions

4.72 These organizations, which are co-operatives operating in the financial field, are specifically exempt from income tax under the present legislation. Originally caisse populaires and credit unions were small organizations serving limited groups of people basically on a non-profit basis. However, with the increased scope of their activities and operations, some of them are in real competition with other financial institutions.

4.73 The government proposes to treat caisse populaires and credit unions as other co-operatives are treated. They would of course be granted deductions for doubtful debt reserves and market liquidity reserves comparable to those allowed to banking institutions.

Starting the System

4.74 The full deductibility of capital losses suffered on the disposal of shares of closely-held Canadian corporations gives rise to a need for special transitional arrangements affecting those corporations. This need may best be explained by giving an example.

4.75 A corporation which purchased an apartment building 10 years ago might now have a balance sheet somewhat as follows:

Apartment building, at cost		$500,000
Less accumulated depreciation		200,000
		300,000
Land, at cost		50,000
Total assets		$350,000
Mortgage payable		$205,000
Shareholder's equity:		
Common shares	$75,000	
Accumulated earnings	70,000	145,000
		$350,000

4.76 Under the existing system, the shareholders of the corporation would be liable for personal tax if the accumulated earnings of $70,000 were distributed. Further, if the apartment building could be sold for $500,000, there would be corporation tax due on the $200,000 of recaptured depreciation, and personal tax as well when the net proceeds were distributed to the shareholders.

4.77 Assuming the shares of this corporation are worth $345,000 at the start of the system ($500,000 for the building plus $50,000 for the land, less $205,000 for the mortgage), both of these taxes would be forgiven. The corporation would still pay a tax on the recapture of the depreciation ($200,000 at 50 per cent = $100,000) and a dividend of the resulting accumulated earnings of $170,000 would still need to be reported by the shareholders as income of $270,000, including the taxable credit of $100,000. However, on winding up the corporation, the shareholders would have a deductible loss of $270,000—their opening valuation of $345,000 less $75,000 received on winding up. This loss would offset the dividend income and the shareholders would receive a refund of the $100,000 corporation tax paid by the corporation.

4.78 Two provisions are proposed to ensure that the taxes which would become due under the existing tax system are not forgiven. As the earnings accumulated before the new system begins—"undistributed income on hand" to use the technical phrase—are distributed, a special 15-per-cent tax would be levied. The distribution would then be

considered as a return of capital to the shareholders, offsetting part of the cost or beginning value of their shares. This procedure would continue, and extend somewhat, the existing provision concerning distributions of undistributed income on payment of a flat-rate 15-per-cent tax. Corporations could elect to treat early distributions as being of this nature and so clear up their situation.

4.79 To secure tax on the recapturable depreciation, it is proposed that part of the tax paid by closely-held corporations be treated as non-creditable until non-creditable tax has been collected on the amount that would have been taxable under the present system. This would of course not accomplish the objective with respect to corporations that are to be treated as partnerships. Shareholders of such corporations would have to elect to value their shares in the same manner as a proprietor or partner is to value his business assets—at values that would leave inventory profits and recapturable depreciation taxable.

5

Business and Property Income

5.1 The Income Tax Act provides that the computation of income from a business or property shall begin with a determination of the profit from the business or property in accordance with normal commercial or accounting principles. Then a series of provisions provide that, in certain circumstances, particular rules will be followed for tax purposes even though these rules differ from those in use commercially.

5.2 Some of these rules make it clear that certain expenditures may not be deducted; for example, personal or living expenses. Other rules specify the year in which certain other expenditures may be deducted. For example, the rules concerning capital cost allowance specify how fast taxpayers can deduct the cost of buildings and other depreciable assets which they use in the course of earning income. Still other rules specify the time at which certain items of income are taken into account. A taxpayer who sells a property for $10,000 down and a $90,000 mortgage stretching over 10 years would for financial statement purposes show that he had made a profit on that sale equal to the difference between $100,000 and the price he paid for the property. He might not, however, have received enough cash to pay the tax on the profit, and the mortgage might not be marketable. As a result, the tax act permits the taxpayer to report his income on a sale of this nature year by year as he receives the payments under the mortgage.

5.3 By and large this general system has worked well and the government does not propose any radical changes at this time. The proposal to tax capital gains and allow taxpayers to deduct capital losses would, of course, apply to the assets of a business, and would constitute another case in which the tax act provides a special rule which overrides commercial practice if there is a conflict. However, certain aspects of the system have created troubles and the government does have proposals to advance for resolving these difficulties.

The "Nothings"

5.4 There is a class of expenditure incurred by businesses that is not deductible, either in the year in which the expenditure is incurred or over a series of years. The taxpayer is prohibited from deducting them in the year in which they are incurred because they are capital expenditures. He is prohibited from deducting the cost over a number of years by way of depreciation because they do not give rise to an asset for which provision is made in the depreciation regulations. Perhaps the best known of these capital nothings is goodwill. If a Canadian buys a business, he can neither deduct nor depreciate the portion of his purchase price that relates to the goodwill of the business.

5.5 The government proposes to create a new depreciation class which would sweep up all of

these nothings and which would enable the taxpayer to deduct 10 per cent of the book value of this class each year. We believe that the 10-per-cent rate is fair if one takes into account the type of expenditure to be included.

5.6 This proposal would be impossible without a tax on capital gains. For as long as the proceeds of the sale of goodwill, among other things, remained tax-free, it was impossible to give a deduction for the cost of purchasing goodwill without creating a leak in the tax system. This leak would cost significant amounts of revenue even under ordinary commercial practices, and the revenue loss would be greatly increased as a result of taxpayers arranging their affairs to take maximum advantage of the situation.

5.7 The goodwill of a business has been described as the value that can be placed on the fact that customers are more likely to trade with that firm than with a new firm in the same line. This likelihood arises in part as a result of advertising and in part because customers have been satisfied in their past dealings with the firm. Clearly, goodwill is a thing that must be kept up. If a firm stops advertising or if it stops giving satisfactory service, its goodwill will disappear. Therefore, the goodwill that a firm has now is the result of its past actions, and the goodwill that it has five years from now will be the result in part of its past actions and in part of its actions in the next five years. The government proposes to recognize this fact in the treatment of taxpayers who sell goodwill in the future. The longer the period after the beginning of the new system before the sale takes place, the more of the proceeds of sale that would be taxable and the smaller the part of the proceeds that would be exempt.

5.8 Another fact must be taken into account in setting the treatment of early sales of goodwill: purchasers would be willing to pay more for goodwill under the proposed system (since they can deduct the expenditure for tax purposes over a period of years) than they are willing to pay under the existing system. With these factors in mind, the government proposes that taxpayers who sell goodwill in the first year of the new system would be taxable on 40 per cent of the proceeds and exempt on 60 per cent; if in the second year, taxable on 45 per cent and exempt on 55 per cent; and so on, with the taxable portion increasing by 5 percentage points each year until the thirteenth year when 100 per cent of any proceeds would be taxable. Naturally, if a sale of goodwill involves a business that was not in existence when the new system commences, all of the proceeds would be taxable even though the sale takes place before 12 years have passed.

Entertainment and Related Expenses

5.9 Although the government believes that provision should be made for the deduction of legitimate business expenses that have not previously been deductible, it also believes that the present system permits deduction of certain types of expenses which taxpayers should be expected to meet out of tax-paid income. Consequently it is proposed that the Income Tax Act specifically deny deduction for entertainment expenses, the costs of attending or sending employees to conventions, and the cost of dues for membership in social or recreational clubs. This provision would not prohibit the expenditure of funds for these purposes, but it would ensure that taxpayers who wish to make such expenditures would do so out of after-tax dollars.

5.10 Under the system outlined in Chapter 4, whereby shareholders are given credit for the tax paid by their corporations, merely denying a deduction for this type of expenditure is not sufficient. Although the denial of the deduction would mean that the corporation pays extra tax, the shareholders of the corporation would receive credit for the extra tax paid. Therefore, it is necessary to provide further that, in the case of corporate taxpayers, taxes due because of the non-deductibility of these expenditures would not be creditable.

Depreciation

5.11 The government believes that the present system of computing depreciation—capital cost

allowance, as it is called in the act—has served Canada well. Under this system, each of a taxpayer's depreciable assets that he uses to earn income is assigned to one of 25 classes. The cost of these assets creates a net book value for assets of the class. The depreciation he claims year by year reduces the net book value of the class, and, should he sell one of the assets, the proceeds of sale also reduce the net book value of the class. At the end of each year, the taxpayer may deduct as depreciation a maximum amount for each class determined by multiplying the net book value of the class by a specified percentage. (The percentage for concrete buildings is 5 per cent; for most machinery, 20 per cent; and for trucks and cars, 30 per cent.) These percentages have been chosen bearing in mind the average useful life of the assets in the class, and also bearing in mind that each year's depreciation reduces the net book value of the class, thereby reducing the maximum amount of depreciation for subsequent years. A taxpayer need not deduct the maximum amount of depreciation permitted. He can deduct any amount he chooses—or none at all—as long as it does not exceed the maximum amount allowable for that year.

5.12 Because each year's depreciation reduces the maximum amount that may be claimed in subsequent years, machinery is not fully depreciated in five years as might appear to be the case in view of its 20-per-cent rate. The maximum deductions on $1,000 of machinery in the first five years are $200, $160 (20 per cent of $800), $128 (20 per cent of $640), $102.40, and $81.92; leaving $327.68 yet to be depreciated after five years.

5.13 If one of the assets in a class is sold for more than the net book value of the class at that time, this is taken as an indication that the depreciation deductions permitted the taxpayer in previous years were too generous, and the difference is treated as taxable income. Some of the earlier depreciation is said to be "recaptured". On the other hand, if a taxpayer sells all of his assets in a class and still has a net book value for that class, this clearly indicates that the past depreciation deductions have not been generous enough. Therefore, he is permitted to deduct the remaining net book value immediately.

5.14 The system has without doubt proven easy to comply with, and has caused far fewer difficulties between taxpayer and taxgatherer than the more usual "straight-line" system that preceded it in 1948 and earlier years. One of the reasons that it works so well may be because, on balance, the rates tend to be on the generous side. This generosity has acted as an incentive to taxpayers to modernize and improve their business facilities, but naturally at some cost in government revenue. The royal commission did not recommend reductions in depreciation rates. Perhaps for that reason, the rates were not generally an issue in the public debate on tax reform that has taken place over the past two years. Nevertheless some have suggested that they are too generous, and the government believes that after 20 years of the system it is time for a review. However, depreciation is an important aspect of the tax system and taxpayers should have an opportunity to put forward their views and experience before major changes are considered. Therefore, the government intends in due course to invite briefs on the system and rates of capital cost allowance.

5.15 In the meantime some changes are desirable. Because the depreciation rates apply to net book value, maximum depreciation reduces year by year. Consequently the rates must be higher than under a straight-line system in which the same amount of depreciation is taken each year. This results in higher-than-average deductions in the early years that an asset is owned, and lower-than-average deductions in later years. The longer the useful life of the asset, (and, therefore, the lower the depreciation rate prescribed) the longer it is before the cross-over point is reached. The longest period of higher deductions probably relates to buildings.

5.16 Many taxpayers who would otherwise be in quite high tax brackets have become landlords, and have been able to reduce or eliminate the tax on their other income by claiming the maximum depreciation on their buildings. Ideally this early generosity should be offset by lower depreciation deductions in later years, or by recapture of the

extra depreciation on sale. However, if the taxpayer buys additional buildings—and with the relatively low down payments required, this can often be done out of the tax savings alone—he can postpone almost indefinitely the day when his total depreciation deductions will drop below average. Moreover, since most of the buildings concerned are in the same class, a taxpayer who sells a building can avoid recapture of the proceeds by investing them in another building. Finally, if the taxpayer continues this process throughout his life, the tax postponed becomes tax saved forever. When a taxpayer dies, excess depreciation is not recaptured, and the person who inherits the buildings is entitled to depreciate the full fair market value of the buildings, no matter what net book value his predecessor had.

5.17 The government proposes to close this loophole in three ways. First, as mentioned in Chapter 3, a person who inherits property would for tax purposes inherit the tax cost of that property to the deceased. In this case, that would mean that the inheritor starts with the same base for depreciation as the deceased had when he died. Second, a taxpayer would be prohibited from deducting from other income a loss from holding property if that loss is created by capital cost allowance. (It is also proposed that the same restriction be placed on the deductibility of losses arising from holding property if those losses are created by a deduction of interest or property taxes. Otherwise taxpayers could reduce or eliminate the tax on their current incomes by holding large amounts of speculative property.) Finally, it is proposed that a separate depreciation class be created for each rental building that costs $50,000 or more. This would mean that there would be a day of reckoning for the owner of each large building. As each such building is sold the taxpayer would bring back into income the amount by which depreciation deducted for tax purposes exceeds the depreciation actually suffered, or conversely he would get a deduction for tax puposes immediately if he has in fact suffered greater depreciation than he has been allowed for tax purposes.

5.18 Because the depreciation rates are based on averages, they sometimes turn out to be inadequate. Indeed, as the royal commission pointed out, there are instances in which the net book value of a class of assets becomes greater than the cost of the assets that the taxpayer has on hand at the time. This arises, of course, because the depreciation he has been permitted was not as great as the actual depreciation suffered on some of the assets which he has since sold or scrapped. This problem would disappear in the case of rental buildings which cost more than $50,000 as explained in the previous paragraph. However, it would remain for other assets. Consequently the government proposes that taxpayers be permitted at any time to write a class of assets down to the aggregate cost of the assets of that type still on hand.

5.19 The government also proposes to require corporations to make this type of write-down in any year in which control of the corporation changes hands. This proposal will help to restrict the sale of business losses.

Consolidated Returns

5.20 At present the Canadian tax system treats each corporation as a separate taxpayer. As a result, some groups of affiliated corporations pay more tax in a year than if all operations had been carried on in one corporation. This happens when one or more of the corporations lose money while others have profits. None of the other corporations can reduce their taxable income by the amount of this loss.

5.21 At one time, the act permitted a group of corporations to file a consolidated return—that is, a return dealing with the net profit or loss of the group of corporations. Corporations which took advantage of this provision were required to pay a corporation tax rate 2-per-cent higher than normal. However, this provision was dropped in 1949. From time to time there have been requests that the privilege of consolidated returns be reintroduced.

5.22 The government considers that its proposal whereby a corporation can be treated as a partnership would permit groups of corporations to achieve the same result as they would under consolidated returns. Therefore, the government does not propose to provide for consolidated returns as such.

Mining and Petroleum

5.23 For many years special rules have been applied in determining the income derived from mining and from the production of oil and natural gas. These rules deal with the deduction of exploration and development expenses, the treatment of the purchase and sale of mineral rights, the exemption of the profits derived from a new mine during the first 36 months of commercial production, percentage depletion for operators, non-operators, and shareholders, and for the treatment of prospectors and grubstakers.

5.24 The government has concluded that special rules are still needed for the mineral industry, but that they should be revised substantially to ensure that really profitable projects bear a fair share of the burden of taxation. It is recognized that the exploration for and development of mines and oil and gas deposits involve more than the usual industrial risks and the scale of these risks is quite uncertain in most cases. Consequently, special arrangements are desirable to ensure that the costs of exploration and development may be charged for tax purposes as early as possible in order that taxes will only be applied when it is clear that a project will be profitable. Secondly, it is recognized that the exploration for and development of mineral deposits continue to provide special benefits to Canada and to various provinces by creating or maintaining highly productive industry in areas other than those where rapid urban and industrial growth are already occurring as a result of both private and public efforts. Just as scientific research and development are believed to warrant some special public support, the government feels that the exploration for and development of minerals still warrant some support in a form more directly related to this activity than has been the case with past depletion. It is believed that support on a less-generous scale should suffice for this purpose.

Exploration and Development Costs

5.25 The present rules concerning exploration and development costs accomplish the objective set out in the preceding paragraph: the costs of mineral exploration and development can be deducted for tax purposes early enough so that taxes will be applied only when it is clear that a project will be profitable. Under these rules, a corporation which has as its principal business either mining, the production of oil, or certain allied activities (refining and/or distributing petroleum or petroleum products, fabricating metals or operating pipelines), may deduct Canadian exploration and development costs as they are incurred. If these costs exceed the corporation's income, then it may deduct the balance of the costs in the first subsequent year in which it has enough income.

5.26 Other taxpayers may also deduct exploration and development costs as they are incurred, but if they do not meet the principal business test mentioned above, they may deduct them only from income from mineral properties. This rule has guaranteed that tax was not paid until these costs were recovered, but it has meant that taxpayers who were unsuccessful in their mineral projects have suffered losses that were not deductible for tax purposes. To cure this defect, it is proposed that taxpayers who fail to meet the principal business test be entitled to put their future exploration and development expenses in an asset class and to deduct annually part or all of their accumulated undeducted expenses up to a maximum of the greater of two amounts:

(1) their income from mineral properties before any deduction in respect of exploration and development expenses,

or

(2) 20 per cent of the net book value of the class.

For this purpose, income from mineral properties would include producing profits, royalties received, and the proceeds of the sale of mineral rights.

The Purchase and Sale of Mineral Rights

5.27 Since 1962, the cost of acquiring oil rights or natural gas rights has been included in the definition of exploration and development expenses. Consequently these costs have been deductible for tax purposes within the limits of the rules relating to exploration and development expenses. It is proposed that this rule be retained, and that it be expanded to cover the costs of other mineral rights.

5.28 Also since 1962, the proceeds of sale of oil rights and natural gas rights have been treated as taxable income. As part of the proposal to tax capital gains, this rule would also be extended to apply to all mineral rights. A special rule would be applied to the proceeds of the sale of rights which are held on the day this White Paper is published if the proceeds of the sale of those rights would not have been income for tax purposes under the existing rules. This special, transitional rule is similar to that proposed in paragraph *5.8* with respect to existing goodwill; if the sale is in the first year of the new system, only 60 per cent of the proceeds would be taken into account; if in the second year, 65 per cent; the third year 70 per cent; and so on, increasing by 5 per cent each year until all of the proceeds are taken into income if the sale is in the ninth or a subsequent year. Since the cost of these rights would henceforth be deductible for tax purposes, prices should rise and this system should produce a fair after-tax return to the present owners.

New Mines

5.29 In addition to their exploration and development expenditures, mining corporations spend large sums of money on mining machinery and buildings before they know whether their new mine will be profitable. In order to recognize this risk, the government proposes to put depreciable assets of this type acquired for production from a particular new mine in a separate asset class and to permit the taxpayer to write them off for tax purposes just as fast as he has enough income from the new mine to absorb the charge. The assets concerned are those described in paragraphs (g) and (k) of class 10, which read as follows:

> "(g) a building acquired for the purpose of gaining or producing income from a mine (except an office building that is not situated on the mine property and a refinery)
>
> "(k) mining machinery and equipment acquired for the purpose of gaining or producing income from a mine."

5.30 This provision would not replace the existing right to deduct 30 per cent of the net book value of assets in this class: it would supplement it. If the new mine produces sufficient profit to absorb a deduction of more than 30 per cent, the taxpayer could make that deduction. If it does not, he could nevertheless deduct up to 30 per cent if he chooses, thereby either reducing other income or producing a business loss which could be offset against income in other years.

5.31 Once the provisions concerning exploration and development costs, the costs of acquiring mineral rights, and the costs of mining machinery and buildings are in place, taxpayers can be pretty well assured that they would not be taxed on mining ventures until after they recover their investment. Having provided that assurance, the government proposes to phase out the present three-year exemption for new mines.

5.32 At present the profits derived from the first three years of operation of a new mine are exempt from Canadian corporate tax. This provision provides an incentive to corporations to commit the large amounts of money necessary to develop a mine, and recognizes that this commitment must often be made at a time when the extent and quality of the ore body cannot clearly be ascertained. However, the government believes that in many instances the three-year exemption is too generous. Neither exploration and development costs nor depreciation need be deducted during the exempt period. As a result, many more than three years' profits are effectively exempt, and taxpayers can recover much more than their investment without becoming taxable.

5.33 In other cases, where the profits of the first three years are low relative to the capital invested in the mine, the 30-per-cent limit on the depreciation of mine machinery and buildings can result in the venture becoming taxable long before it is clear that it will produce enough revenue to pay for the investment.

5.34 The government believes that the proposed package is more appropriately tailored to the needs of the situation. It should provide a powerful incentive to taxpayers to undertake the risk inherent in opening a new mine. It should also, within the limits of what is possible within the tax system, facilitate their financing of the mine, since it would mean that all of the profits would be available to repay loans until enough has been earned to repay the initial financing entirely. At the same time, it would exact from the truly profitable mining venture a fair contribution towards the costs of government.

5.35 The present three-year exemption would continue to apply until December 31, 1973, in accordance with the announcement made by the then Minister of Finance in May, 1967. New mines which have come into production in commercial quantities before the publication of this White Paper would be eligible for the exemption but would not be able to take advantage of the new proposal concerning fast write-off. New mines which come into production after the publication of this White Paper but before January 1, 1974 would be entitled to elect to take advantage of either incentive but not both. Specifically, they would be entitled to claim exemption of the profits earned either in the first three years of operation or in the period remaining to January 1, 1974, if that is shorter. At the end of the exempt period they would be entitled to the fast write-off of the capital cost of their mine assets, but only if they reduce the book value of those assets by the full amount of their exempt profits.

Percentage Depletion

5.36 At present, the act provides that operators of mineral resources, and this phrase includes oil and gas wells, are entitled to reduce their taxable income by claiming depletion allowances. For the most part these depletion allowances are calculated as a percentage of the profits derived from production from the mineral resource, and the usual percentage is 33⅓ per cent. Special rates of depletion are provided for gold and for coal.

5.37 Originally, these allowances were intended to recognize that an ore body or a pool of oil was of a limited size, and that part of the proceeds of the sale of the mineral was a return of the capital investment in the resource. In those days many of the costs of acquiring and developing mineral rights were not deductible for tax purposes and depletion allowances made up for this fact. However, over the years more and more of the costs have become deductible, until under these proposals all such costs would be deductible. Depletion allowances would no longer be needed for the accurate measurement of income from a mine or field: they would be transformed into an incentive designed to induce taxpayers to undertake more exploration and development than they otherwise would. Other countries, and most notably the United States, have similar incentives in their law.

5.38 As mentioned earlier, the government has concluded that the tax system should continue to contain in incentive of this nature. However, it believes that the present incentive is inefficient in two respects. First, depletion applies to all production profits regardless of the exploration effort of the taxpayer. It is only indirectly related to the activity it seeks to encourage. If a taxpayer stumbles on a mine, he would, under present rules, be entitled to a depletion allowance against the profits from that mine for all time to come, even if he never spends another cent exploring for minerals.

5.39 A second inefficiency is also related to the fact that the depletion allowance applies to all production profits without limit. Because exploration and development costs must be deducted in computing production profits for this purpose, the operator of a mineral resource can logically claim he is inhibited from engaging in exploration by the rules concerning depletion. The exploration costs reduce the depletion allowance: therefore it

can be argued that the provision designed to increase exploration can in some cases reduce it.

5.40 The government believes that both of these inefficiencies can be substantially reduced if depletion allowances are more directly related to the activities which it is desired to affect. Consequently it is proposed that, after a suitable transitional period in respect of mineral rights held by the taxpayer on the day this White Paper is published, depletion allowances would have to be "earned". The existing maximums would continue to apply—that is, generally no more than 1/3 of production profits—but a taxpayer could only deduct these maximums, or any amount, if he spends enough on exploration for or development of mineral deposits in Canada or on those fixed assets described in paragraph *5.29* that are acquired for the exploitation of a new Canadian mine. The formula proposed is that for every $3 of eligible expenditures made after this White Paper is published a taxpayer would earn the right to $1 of depletion allowance. If his profits that year are not sufficient to permit him to deduct the amount earned, he could carry the undeducted amount over to subsequent years. The cost of acquiring mineral rights would not be an eligible expenditure for this purpose.

5.41 Under the proposed system, a taxpayer could run out of depletion allowances unless he continues to explore for, and/or develop, Canadian minerals. Once the system is fully effective, a taxpayer's allowances would end when his profits before "eligible expenditures" exceed twice the amount of those expenditures. Consider the following example:

Profits before eligible expenditures	$6,003
Deduct eligible expenditures	3,000
	3,003
Maximum depletion $1,001 (1/3 of $3,003)	
Earned depletion (1/3 of $3,000)	1,000
Taxable income	$2,003

5.42 The system would not become fully effective immediately. The government proposes that for the first five years of the new system taxpayers be entitled to depletion allowances in respect of production profits from properties they now own without having to "earn" them. This period, combined with the entitlements to the earned allowances that taxpayers would be able to accumulate between the publication of this White Paper and the end of 1975, should enable the mineral industries to make a smooth transition to the new system.

Percentage Depletion for Non-operators

5.43 Under the present legislation a depletion allowance of 25 per cent may be deducted by non-operators from their income from mineral properties. This provision applies principally to the holders of royalties. The concession sought to recognize that royalties might well in part be a return of capital. This fact would under the present proposals be more accurately recognized by the proposed rules concerning the amortization of the cost of acquiring mineral rights. Therefore it is proposed that the percentage depletion at present available to non-operators be repealed.

5.44 Also, under the present legislation a depletion alowance of 10 per cent, 15 per cent or 20 per cent may be deducted from dividends received from a mining or oil company, the percentage depending upon the proportion of the income of the corporation which is derived from production. This concession was meant to recognize that the corporation might in fact be paying dividends out of capital. Under the new system this fact would be more accurately recognized by the deduction granted to taxpayers for losses realized on shares which they have held. Therefore it is proposed that shareholders depletion be removed.

Prospectors and Grubstakers

5.45 For many years the act has continued a provision which specifically exempts from tax the proceeds received by a prospector or a grubstaker on the sale of a mining property. This pro-

vision was intended to make it clear that the government viewed this type of gain as a capital gain which under the existing system would of course be tax-exempt. Under the new proposals capital gains are to be taxed and this exemption would therefore be repealed.

Taxpayers in the Professions

5.46 Generally, taxpayers who are in business must compute their taxable income on what is known as the accrual basis. This means that a merchant must take into account the inventory of goods he has on hand, the amounts due to him from his customers, and the amounts he owes to his suppliers. An exception to this general rule has for many years been made for taxpayers in the professions (doctors, dentists, lawyers, chartered accountants, professional engineers, etc.). These taxpayers have been permitted to choose to report their income either on the accrual basis or on the cash basis—that is, they could omit the amounts due them from their clients and their "inventory" of unbilled time. Once a taxpayer chooses one basis he cannot switch to the other without the consent of the Minister. The government believes that the tax postponement permitted by this concession has given professionals an unwarranted advantage by comparison to the rest of Canadians, and it therefore proposes that professionals be required to use the accrual basis.

5.47 A problem would exist in switching professional taxpayers now on the cash basis over to the new system. This problem relates to their receivables and inventories at the date of the change over. For example, if 1971 is the first year of the new system, the problem would relate to the receivables and inventories as at the end of 1970. These amounts would not have been included in the taxpayer's 1970 income because they would not have been collected at that time. They would not be included in the 1971 income because they were earned before that time. To require that the entire amount be brought into 1971 income would impose an abnormal tax liability in that year. As a consequence, the government proposes that these taxpayers be entitled to bring these amounts into income over a number of years. Specifically, they would bring them into income as their total outstanding receivables and inventories are reduced. This amount would of course be in addition to the amount of their income computed on the accrual basis and would mean that they would be taxed on the greater of a cash-basis income or an accrual-basis income until they catch up to other Canadian businessmen.

Farmers and Fishermen

5.48 Farmers are also at present entitled to compute their income on a cash basis. The government has given serious consideration to this provision and has concluded that it should remain. As regards market farmers, their inventories are so perishable that year-end inventories are not significant. Under present marketing arrangements, grain farmers are not permitted to sell their own inventories and it would be unfair to require them to pay tax on an amount that they could not take steps to realize. This leaves livestock farmers.

5.49 Livestock farmers have been able to treat part of their herds as a capital investment. The cost of acquiring or raising these animals is a non-deductible capital expenditure and the proceeds of their sale gives rise to a non-taxable capital gain. Under the government's proposals capital gains would in future be taxable so that this "basic herd" concept would be obsolete. It is not thought appropriate to add a change to accrual accounting on top of this "basic herd" change.

5.50 The government does not propose to tax capital gains that accrue before the new system begins. Consequently the fair market value of a farmer's basic herd at the beginning of the new system would be tax-exempt. His basic herd would be treated as an inventory of animals that he purchased at their fair market value at the commencement of the system.

5.51 Farmers and fishermen are now entitled to avoid the recapture of depreciation on the sale of their depreciable assets if they claim depreciation

on what is called the straight-line system—computed at rates generally one-half of those used under the asset-class system. Any profit on the sale of such a depreciable asset is considered a capital gain. Once capital gains are taxable, the advantages of the straight-line system disappear and farmers and fishermen would find it advantageous to use the asset-class system because

(1) of the more generous rates, and
(2) profits on the sale of assets reduce the base for subsequent depreciation rather than bearing tax immediately.

Naturally, the proceeds of the sale of assets owned on the day the system starts would continue to be tax-free to the extent that they represent a capital gain accrued to that date—that is, the fair market value exceeds the net book value of asset on commencement day and the taxpayer is able to realize that excess.

5.52 Section 13 of the Income Tax Act limits the deductibility for tax purposes of losses suffered on the operation of what are commonly referred to as "hobby farms". A taxpayer who is not primarily a farmer can deduct only $5,000 of farming losses annually from his other income—all of the first $2,500 of losses and half of the next $5,000.

5.53 Because this provision is intended to prohibit the deduction of personal expenses from taxable income, it would remain in the act under the new system. A taxpayer would, however, be allowed to reduce these non-deductible losses by capitalizing property taxes on the farm and interest paid on loans related to the purchase of the farm. By "capitalizing" we mean adding the amount involved to the cost to the taxpayer of the farm. This procedure would reduce the capital gain taxed on the sale of the farm, but it would not be allowed to increase the capital loss that may be deducted.

Investment Income of Clubs and other Non-profit Organizations

5.54 The present law contains a provision—section 62(1)(i)—that exempts from income tax social, recreational and service clubs, societies and associations which operate on a non-profit basis. (This provision does not cover registered charities which are exempted under other paragraphs.) The government does not propose to change the exempt status of the basic functions of these organizations, but when they accumulate investment portfolios, it believes that the investment income therefrom should bear income tax. Therefore it is proposed that the investment income of organizations which are covered by section 62(1)(i) be subjected to the corporation tax.

Trusts

5.55 Under the present tax system, all taxable trusts are subject to the same set of rules, the most important of which are as follows:

(1) generally income received which is payable to beneficiaries in the year received is taxable to the beneficiary not the trust,
(2) income that is not so payable is taxable to the trust, and for this purpose the trust uses the personal rate schedule (although it is not entitled to a personal exemption), and
(3) once the trust has paid income tax on an amount, the balance can usually be distributed in subsequent years without further tax.

5.56 Because a trust is not taxed on income which is payable to its beneficiaries during the year, many trusts do not pay any tax at all. Some of these trusts are in direct competition with widely-held public corporations and have as many beneficiaries (in this case usually unit holders) as some public corporations have shareholders. The tax rules give these trusts an advantage over their competitors. It is proposed that a trust be treated as a corporation if it has issued transferrable or redeemable units, each of which represents a specific undivided interest in the trust property. If the number of unit holders and marketability of the units warrant it, the trust would be treated as a widely-held corporation. If such a trust were a mutual fund, it would be taxed in the same manner as an incorporated mutual fund.

5.57 The fact that a trust is entitled to use the personal rate schedule in computing its tax means that income accumulated in a trust may bear significantly less tax than if the income were taxable to the beneficiaries, and the tax saving is not offset by a further tax when the funds are eventually distributed. (The number of accumulating trusts has increased significantly during the past few years.) If a trust is covered by the proposal set out in the preceding paragraph, this loophole would no longer be available. To close it for other trusts, it is proposed that income accumulating in such trusts be subject to a flat-rate federal tax of 40 per cent; provincial taxes would increase this rate to the neighborhood of 50 per cent and the corporate rate. A special relieving provision would reduce the rate in the case of trusts or estates arising on the death of someone whose economic circumstances were such that a 50-per-cent rate is not appropriate, provided no additional property is transferred to the trust by anyone else.

5.58 Less is known of the use to which trusts are put in Canada than is the case with respect to corporations, and given the varied uses that are possible, it is difficult to foretell all of the effects of the proposal discussed in the preceding paragraph. Consequently the government issues a particular invitation to taxpayers who believe that they would be unfairly treated under it to make the facts of their case known to the Department of Finance so that modifications can be considered.

6

Taxing International Income

6.1 The over-all thrust of Canada's present provisions for taxing the Canadian income of non-residents is generally regarded as reasonable. The Canadian wages and business profits of non-residents are taxed at the ordinary rates applied to Canadian taxpayers, and dividends, interest, and other categories of investment income are subject to a flat-rate withholding tax not exceeding 15 per cent. This treatment is well within the international norm, and it may fairly be said that our tax system does not seek to discourage non-residents from investing or carrying on business in Canada.

6.2 Similarly, the Canadian tax treatment of the foreign income of Canadians does not seek to discourage Canadians from investing or carrying on business abroad. Canadian residents with foreign income obtain double taxation relief in either or both of two ways. The foreign tax credit provisions generally permit a dollar-for-dollar reduction of Canadian tax for income taxes imposed abroad. In addition, dividends received by Canadian corporations from subsidiaries and certain other affiliated companies abroad are exempt altogether from Canadian corporate tax.

6.3 While these provisions relating to non-residents and to foreign income are fair in themselves, the fact that at least two countries are involved in the taxation of international income means that they do not guarantee that the over-all tax burden is reasonable. Depending on the circumstances abroad, international income may well be over-taxed or under-taxed.

6.4 Some countries do not levy income taxes. Other countries levy income taxes but do not apply them to particular types of income. Taxpayers, both here and abroad, have not been reluctant to use such jurisdictions to artificially reduce or unduly postpone the Canadian taxes they would otherwise pay. Some types of income (e.g. foreign dividends, rents and royalties, shipping income and some export profits) are easily diverted to the so-called tax-haven jurisdictions. Canadian taxes are thereby at least postponed until the funds are needed in Canada, and may be avoided altogether. In some instances, Canadian income can also be routed through a tax haven to produce a tax advantage. Consider a Canadian corporation contemplating the purchase of a Canadian bond. If it buys the bond itself, the interest will bear corporate tax of 50 per cent. If, however, it causes a wholly-owned corporation in a tax-free jurisdiction to buy the bond, Canada will settle for a 15-per-cent withholding tax on the interest, and the subsidiary corporation can distribute the funds to its Canadian parent corporation tax-free by way of a dividend. A number of the proposals in this chapter are designed specifically to counter such manoeuvres. A number of other proposals call for the restriction to tax treaties of a variety of privileges at present extended to all. In this way concessions can better be confined to those who are intended to benefit.

6.5 Unfortunately, the taxing statutes of some other countries place considerably higher rates of tax on non-residents than does Canada and are less generous in relieving the tax burden on foreign income. While such countries very often do seek to alleviate the double burden of tax on international income, the relief is on a selective basis. For example, relatively high statutory withholding rates of tax on dividends, interest and royalties are reduced in tax treaties, but the lowering of rates and other concessions are restricted to income flowing between the contracting countries. The emergence in recent years of bilateral tax treaties as the principal means by which a number of other countries seek to alleviate international double taxation—a desirable development in many respects—has one unfortunate side effect. It results in discrimination against both investment in and residents of non-treaty countries. Canada must ensure that this form of discrimination does not adversely affect its interests.

6.6 It seems clear that in order to continue to attract the foreign capital essential for its development and to open up further opportunities for Canadian exporters, Canada must seek to overcome tax obstacles placed in the way of foreign trade and international investment by other countries. To do this Canada must improve its network of tax treaties with other countries. The government will attach a high priority to this task.

6.7 These comments, by way of introduction, provide a necessary background for the proposals that follow. The remainder of the chapter is divided into two parts and describes first, the proposals relating to the foreign-source income of Canadians and second, the proposals relating to the Canadian income of non-residents.

FOREIGN-SOURCE INCOME OF CANADIANS

General Objective

6.8 The proposals are designed neither to provide an incentive to Canadians to invest abroad, nor to place a barrier in the way of their doing so. For the foreseeable future Canada's capital requirements will continue to exceed available domestic savings. At the same time there is an abnormal degree of foreign ownership of and control over Canadian industry. In these circumstances it would clearly be inappropriate to encourage the export of investment capital needed domestically.

6.9 On the other hand, Canadian business is often required to go abroad to seek foreign sources of supply and to develop foreign markets. Going international is frequently necessary to enable Canadian companies to achieve the economies of scale which are otherwise denied them by the relatively small size of the Canadian domestic market. Such companies would find it hard to compete on the international scene if they were subject to more onerous taxes than those which apply to their competitors. Moreover, it is in Canada's interest as a substantial capital-importing nation to maintain an international climate hospitable to the unrestricted flow of capital across international boundaries.

6.10 While the proposals should not impede foreign investment by Canadians, that is not to say that the over-all tax system will not influence the choice between a domestic and a foreign investment. The proposal that Canadian shareholders be given credit for part of the Canadian tax paid by corporations will introduce a preference on the part of shareholders to invest in Canadian corporations, and particularly in Canadian corporations with Canadian operations. However, there is a difference between an incentive to investment in Canada and a disincentive to investment abroad.

6.11 The system by which the government proposes to attain its objectives is set out in the following paragraphs. These paragraphs deal successively with dividends from controlled foreign corporations, passive income of controlled foreign corporations, other foreign investment income, business profits and salaries and wages earned abroad by Canadians, and a new procedure for giving shareholders of Canadian corporations credit for the foreign withholding taxes paid by their corporations.

Dividends from "Controlled" Foreign Corporations

6.12 Most developed countries use one of two general systems to provide that their corporations do not bear unduly heavy income taxes if they carry on business abroad through subsidiary corporations. One system, which is used by most European countries, exempts the dividends received by a resident corporation from foreign corporations which it controls. The present Canadian provisions fall in this general category. The rationale of this system may be over-simplified as "if a corporation tax should be collected, the country in which the profits are earned will collect it, and any further corporate tax collected by the country in which the holding corporation is located would be 'double taxation' and a fiscal barrier to international investment."

6.13 The other system, which is used by the United States and the United Kingdom, taxes the holding corporation on the dividends it receives from foreign corporations which it controls, but grants the holding corporation a credit for the foreign corporation taxes paid by the foreign corporation on the profits from which the dividend was paid. The rationale of this system might be over-simplified as "all corporate profits should bear corporation taxes at rates at least as high as ours, and if the country in which the profits are earned does not collect enough corporate tax, we will collect the rest when you bring the profits home."

6.14 The choice between the two rationales is obviously influenced by one's opinion as to who bears the corporation tax. If the tax is passed on to the customers of the corporation, then the pricing and profit structure of the local corporations in a country likely contemplate the payment of the local corporation tax, and any additional corporate tax would place an international corporation at a competitive disadvantage. On the other hand, if the tax is borne by the shareholders of the corporation, there is no reason why shareholders of corporations with foreign operations should bear less corporate tax than shareholders of corporations which operate in the home country. Unfortunately, although the problem of the incidence of the corporate tax has been the subject of extensive research and analysis, the answer remains largely a matter of opinion. In Chapter 4 we stated that we consider it likely that some level of corporation tax is passed on to customers in the prices which international corporations charge for their goods and services. Undoubtedly the extent of shifting varies considerably from one situation to another: from one country to another, from one product to another, and from one point in time to another.

6.15 The government has concluded that neither of these systems is either "right" or "wrong". It proposes to continue in a restricted form the present exemption of dividends received by a Canadian corporation from a controlled foreign corporation. For this purpose, the Canadian corporation would be assumed to control the foreign corporation if it owns 25 per cent or more of the voting shares of the foreign corporation. The first restriction proposed is that the exemption privilege would be extended only to dividends from those countries with which we have concluded bilateral tax treaties. A second is that the effect of the exemption would be eliminated for certain types of diverted income by the proposals described below under the heading "Passive Income of Controlled Foreign Corporations." These restrictions are necessary to frustrate efforts to use the dividend exemption to reduce artificially the tax burden on tax-haven income.

6.16 Where it applies, the exemption system would permit Canadian corporations to compete abroad without being at a fiscal disadvantage vis-a-vis their competitors, including the competing subsidiaries of European corporations. It is obviously an easier system to comply with than the foreign tax-credit system, although corporations would have to be able to show that their controlled foreign corporations do not run afoul of the passive income provisions. If it is slightly generous in some circumstances, it should not divert Canadian investment abroad; to do that it must compete with the system of credit for Canadian corporate tax. And, of course, Canadian personal tax would still be due when the profits are distributed to Canadian shareholders.

6.17 A dividend from a Canadian-controlled foreign corporation not protected by tax treaty would be subject to a tax-credit regime. The Canadian corporation would be allowed a credit for the foreign withholding taxes imposed on the dividend and for any foreign corporate tax imposed on the underlying business profits from which the dividend was paid. This would reduce or eliminate taxes due on the dividend, which taxes would be computed on the dividend plus the tax for which credit was available.

6.18 The existing dividend exemption system would be retained for several years, at least through 1973, as a transitional measure until an appropriate network of international tax treaties can be built up.

6.19 Subject to the limitation noted below, the general capital gains provisions would apply to the shares of controlled foreign corporations—gains realized on the disposal of them would be fully taxable and losses fully deductible (except of course to the extent that the gain or loss accrue prior to valuation day). However, because full corporate tax would not be collected on dividends from such corporations it would be necessary to place a limit on the deductibility of losses if the system as a whole is to be effective. Otherwise, Canadian corporations could purchase control of foreign corporations, arrange to receive most of the assets of the company as a special dividend, and then sell the shares for the value of the remaining assets. The dividend would bear little or no Canadian tax because of the foreign tax credit or the exemption, but the loss would reduce taxable income and save Canadian tax. This tax result is clearly inappropriate since the Canadian corporation would not, in fact, have suffered an over-all loss on its investment. To avoid this consequence, it is proposed to reduce the deductible loss on such shares by reference to the dividends received from the corporation that did not bear full Canadian corporation tax.

Passive Income of Controlled Foreign Corporations

6.20 As noted above, the exemption privilege is susceptible to abuse. Not all foreign corporations carry on bona fide business operations. Some are merely devices of convenience to which income from other sources—dividends, interest, royalties and trans-shipment profits—may easily be diverted. The dividend exemption system would permit such income to be brought back to Canada tax-free. Even the tax-credit system would permit the Canadian tax on such income to be postponed indefinitely.

6.21 To counter this type of tax-haven abuse, the United States now provides that when such income is channelled to a controlled foreign corporation, the U.S. controlling shareholders shall be taxed on a current basis whether or not the income is distributed to them. U.S. taxes are levied in the year in which the profits are earned rather than postponed until the profits are returned home. The government proposes to introduce provisions patterned generally on those in the United States. This proposal involves complicated and difficult law, but the problem is serious and defies easy solution.

Other Foreign Investment Income

6.22 At present, a Canadian individual who receives foreign investment income, and a Canadian corporation that receives foreign investment income other than a dividend from a controlled foreign corporation, include the investment income in taxable income and can deduct from the Canadian tax on that income the foreign income taxes he has paid to the government of the foreign country. The government proposes to continue this treatment substantially unchanged. However it believes that in normal circumstances the rate of withholding tax levied on portfolio investment income flowing between countries that have a tax treaty should not exceed 15 per cent. For its part, Canada will be willing to limit its withholding tax on such income to 15 per cent. To achieve balance, it is proposed that the maximum rate of tax for which foreign tax credit would be granted on this type of income be 15 per cent. To provide time for Canada to expand its tax-treaty network, and for taxpayers to rearrange their investments, this rule would not go into effect until 1974.

Business Profits and Wages Earned Abroad

6.23 The present tax treatment of the business profits and wages earned abroad by Canadian corporations or individuals is the same as that for portfolio investment income. The income is taxed as earned, and the taxpayer is entitled to a foreign tax credit for taxes paid to the government of the foreign country on that income. The government proposes to continue that treatment.

6.24 While the government proposes to retain the existing system of taxing foreign business profits, two important changes to the foreign tax-credit provisions are appropriate. Provisions will be put forward to prevent taxpayers from reducing Canadian tax by transferring the operation of a foreign branch which has sustained losses to a foreign company in order to avoid the Canadian tax which should ordinarily be recaptured on subsequent branch profits.

6.25 In addition, the government proposes to amend the foreign tax-credit provisions to permit the excess of foreign taxes paid over the amount creditable in a year to qualify for allowance in other years. The carry-over of the foreign tax credit is intended to alleviate the problem that arises when income is taxable abroad in a different year from that in which it is taxable in Canada.

6.26 In its tax treaties, Canada will also be prepared to recognize the income taxes levied by political subdivisions of foreign countries on a reciprocal basis. If the foreign country is prepared to give a foreign tax credit for the income taxes levied by the provinces, Canada will agree to give a credit or a deduction, whichever is appropriate, for the taxes levied by its political subdivisions.

Flow-through of Foreign Withholding Taxes

6.27 Most countries levy a flat-rate withholding tax on dividends paid by corporations in the country to non-resident shareholders. Canada does so at present, and proposes to continue to do so. As previously explained, when a foreign dividend is received by a Canadian individual, he would get a credit against his Canadian income tax for the foreign withholding tax up to a maximum of 15 per cent. If, however, the Canadian individual invests in a Canadian corporation (say a mutual fund) which owns shares in a foreign corporation, he would not receive a credit for the foreign withholding tax. At present a rough balance is struck since the dividends of the Canadian corporation are eligible for dividend tax credit even though they come from profits that did not bear full Canadian corporate tax. With the proposed more precise and somewhat larger credit for corporation taxes described in Chapter 4, it is no longer feasible to deal with the withholding tax in this rough and ready way.

6.28 The withholding tax on dividends also causes problems for Canadian corporations which have both foreign subsidiary corporations and foreign shareholders. When a foreign subsidiary corporation pays a dividend to the Canadian parent corporation, there is a withholding tax. When the parent corporation uses those funds to pay dividends to its shareholders, there is another withholding tax on the dividends paid to its foreign shareholders. If a foreign shareholder happens to be in the same country as the foreign subsidiary corporation, there are two withholding taxes paid to move profits earned in his country to Canada and then back again. In some groups of corporations, profits can cross three, four or more international borders before they reach the final individual shareholders.

6.29 The government hopes to alleviate both of these problems by allowing 15 percentage points of the foreign withholding tax to pass through the Canadian corporation and to qualify for credit treatment in hands of the final shareholder. An example will help to explain this "flow-through" proposal. Assume a Canadian corporation receives a dividend of $100 less $15 from a subsidiary company incorporated abroad. Under the existing provisions the Canadian parent company could pay out the $85 received to its shareholders. A resident individual would reflect the $85 dividend in his income and pay tax at his ordinary personal rates. A foreign shareholder would receive a net dividend of $72.25 ($85, less 15-per-cent Canadian withholding tax). Under the "flow-through" proposal, the company would be in a position to declare a

dividend of $100 and to recoup the foreign tax by "deducting" $15 from this amount. The resident shareholder would report dividend income of $100 and claim credit for the $15 tax withheld. In the same way the non-resident shareholder would be entitled to a $100 dividend from which the $15 tax had been deducted.

6.30 The "flow-through" privilege would apply to the foreign tax imposed on all foreign dividends. To place foreign branches and subsidiaries on the same general footing, the privilege would also apply to a portion of the foreign tax imposed on branch profits abroad. The amount qualifying for flow-through treatment would be limited in all circumstances to the lesser of (a) the foreign tax, or (b) 15/85ths of the foreign earnings net of all foreign taxes, including withholding tax.

Foreign Business Corporations

6.31 "Foreign business corporation" is a technical expression for a type of corporation that is exempt from Canadian income tax. To qualify, a corporation must carry on all of its business operations, except management and a few other specified activities, outside Canada. Originally, this category was provided to make sure that several large Canadian public corporations with business operations entirely outside Canada did not suffer "double taxation" on their business profits. It did for these corporations what the exemption system did for corporations that operated abroad through controlled foreign corporations.

6.32 However, during the 1950s other corporations appeared that passed the test for Canadian exemption but were not taxable in any other country either, often because of Canada's tax treaties with the countries with which they traded. Canada had become a tax haven. In 1959 Parliament provided that no new foreign business corporations could be created.

6.33 It is repugnant in principle to have a special status for some corporations when others which are identical in every other respect cannot qualify. Moreover, the status granted is inconsistent with the provisions proposed concerning passive foreign income of controlled foreign corporations. (Foreign business corporations could receive investment income tax-free, but controlled foreign corporations would not be permitted to do so.) The government therefore proposes to withdraw the exemption. It would be withdrawn immediately with respect to "passive income", but would be transferred to a foreign tax-credit system over a period of five years for business profits. This would give existing corporations an opportunity to rearrange their affairs. Many would likely be able to avoid double tax by qualifying their foreign operations in controlled foreign corporations.

THE CANADIAN TREATMENT OF NON-RESIDENTS

Withholding Tax

6.34 A notable feature of the present Canadian taxing statute—one which distinguishes it from the taxing statutes of most other countries—is the reasonable rate of withholding tax applied to investment income flowing to foreigners (generally 15 per cent). Most other countries provide withholding taxes at considerably higher rates in their tax law, and reduce these higher statutory rates only for taxpayers in those countries with which special bilateral tax-treaty arrangements have been concluded.

6.35 The high rates in other countries effectively curtail some of the more obvious opportunities for international tax avoidance. The modest rates in Canada have enabled taxpayers to make use of "incorporated pocketbooks", trusts and other devices in tax-haven jurisdictions to artificially reduce the tax load on Canadian-source interest, dividends and royalty payments. The proposal discussed above concerning "passive income" would partially frustrate this opportunity for abuse, but would not eliminate it. A general increase in the rate of the non-resident withholding tax is also necessary.

6.36 Statutory withholding rates usually fall within a range of 25 to 30 per cent, although they exceed 40 per cent in the United Kingdom and

some other countries. The government proposes to increase the Canadian rate to 25 per cent. This increase would, of course, not override the limitations on withholding tax rates contained in Canada's existing tax treaties. Further, Canada would generally be prepared to reduce the rate to 15 per cent in new tax treaties with other countries.

6.37 The increase in the rate of withholding tax would not apply to dividends before January 1, 1974. The delay in implementing the increase on dividends is in recognition of several factors: first, foreign shareholders have always been able to withdraw accumulated profits at 15 per cent and should not be penalized for having reinvested their earnings in Canada; second, Canada would be prepared to conclude tax treaties with most other countries providing for a 15-per-cent rate on dividends and third, most of Canada's existing treaties contain a 15-per-cent limitation.

6.38 The increase would apply to the other categories of income now subject to the non-resident withholding tax from January 1, 1971, with the following exceptions:

(1) As mentioned the increased rates would not override the limitations contained in Canada's existing tax treaties.

(2) The increase in rates would be postponed to January 1, 1974 on interest, rents and royalty payments where the obligation arises out of an agreement in writing concluded before the date on which this White Paper is published.

(3) The rate of withholding tax would remain at 15 per cent on interest payable on bonds or other obligations held by persons dealing at arm's length with the issuer, if the obligation is issued before 1974 and is held by a person resident in a country where Canada's present tax treaty limits the withholding tax to 15 per cent.

6.39 Several special categories of interest (including interest on federal, provincial and municipal debt obligations) are exempt from withholding taxes. These would continue to be exempted. However, interest on obligations issued after January 1, 1974 would only be exempt if the recipient is a resident of a country with which Canada has a tax treaty.

Non-resident-owned Investment Corporations

6.40 The proposed increase in withholding tax rates has implications for that category of corporation known as a "non-resident-owned investment corporation"; an entity taxed at 15 per cent on investment income but exempt from the obligation to withhold tax from distributions abroad. Such companies, while resident in Canada, are generally treated for tax purposes as non-resident persons. They constitute a convenient holding device for foreign investors in Canadian securities. The tax on such companies would be increased to match the rate of the non-resident withholding tax.

Thin Capitalization

6.41 The Canadian tax system contemplates that non-residents who earn business profits in Canada shall pay income tax to Canada at the rates that apply to Canadians. If a foreign individual carries on business in Canada, he is taxed on the profits in accordance with the normal table of progressive rates. If a foreign corporation carries on business here, it is taxed on the profits at the corporate rate of 50 per cent. If the foreign corporation incorporates a Canadian subsidiary, the Canadian corporation is taxed on the profits at 50 per cent, provided the foreign corporation makes its investment in the form of shares. If, however, the foreign corporation makes part of its investment as a loan, the interest on that loan is a deduction in computing business profits. It therefore saves tax at 50 per cent, but it bears Canadian tax only at the withholding rate of 15 per cent (or 25 per cent if not protected by treaty). It is a natural thing for corporations to borrow, and not unnatural for them to borrow from their shareholders, but the difference in tax rates has tempted some to create corporations with very nominal share capital (say $3) and to make virtually all of their investment as an interest-bearing loan.

6.42 No country has yet found a satisfactory tax solution to this "thin-capitalization" problem, although a number of other countries rely extensively on investment restrictions and currency controls to thwart abuse. The government proposes to restrict the deductibility of non-arm's-length interest wherever the ratio of shareholder debt to equity exceeds three to one. Such a provision is necessarily arbitrary and it is difficult to administer. It may have to be altered at a later date in the light of experience.

Capital Gains

6.43 The general proposal to include capital gains in taxable income would require changes to the international provisions, including the extension of Canadian tax to gains by non-residents on the disposal of real property, partnership interests and branch assets in Canada.

6.44 Given the ease with which a gain on the sale of other assets can be transformed into a gain on the sale of shares of a corporation, it would also be necessary to tax certain gains by non-residents on the sale of Canadian shares. This need is strongly reinforced as regards closely-held Canadian corporations by the implications of the regime suggested for Canadian shareholders of those corporations. Since a Canadian can obtain full credit for the Canadian corporate tax paid by the corporation, and can deduct the full cost of his shares from his income when he sells those shares, he can afford to pay the full value of the corporation's assets (including creditable tax as an asset) when he buys the shares of the corporation.

6.45 Consider a corporation in this position:

Assets	
Cash	$ 5,000
Land, at cost	100,000
(present value $150,000)	
	$105,000
Shareholder's equity	
Common shares	$100,000
Retained earnings	
(after tax of $5,000)	5,000
	$105,000

A Canadian could afford to pay $160,000 for the shares of the corporation—$150,000 for the land, $5,000 for the cash, and $5,000 for the creditable tax. If he winds up the company, he would be treated as having purchased the land for $150,000, and as having received a dividend of $5,000 plus a taxable credit of $5,000. Offsetting this he would have a deductible loss of $10,000 on the shares. So he would receive $150,000 worth of land, the $5,000 cash in the corporation and a $5,000 tax refund from the government.

6.46 This is the appropriate result provided the vendor is taxable on his capital gain on the sale of the share. He and/or the owners before him would have paid tax on the full $60,000 on the sale of their shares. Canada would have collected one tax—and only one—on the $60,000. But the vendor must be taxable, or the $60,000 would escape tax. Therefore it is proposed that non-residents as well as residents be taxed on their gains on the sale of shares of closely-held Canadian corporations. This would be buttressed by a "back-up" provision to place a responsibility on the purchaser to ensure compliance. A system of "certificates of compliance" would be necessary for private company share transfers—an awkward but necessary evil.

6.47 The same implications do not apply in the case of widely-held Canadian corporations. Canadian shareholders would receive credit for only half of the corporate tax paid and would be entitled to deduct only half of their loss on the sale of their shares. Also, it would be impracticable to attempt to tax non-residents on their sales of small lots of these shares. Therefore it is proposed that only those non-residents who are selling shares out of a substantial interest (25 per cent or more) would be taxable in Canada.

Branch Profits Tax

6.48 A foreign corporation which carries on business in Canada through a branch is liable for a special 15-per-cent tax on net after-tax profits it has available for withdrawal from Canada. This tax is counterpart to the 15-per-cent withholding

tax applied to dividends paid by Canadian corporations to foreign shareholders. The rate would be increased in parallel with the change in the withholding rate on dividends.

6.49 The formula for measuring the profits available for withdrawal contains a deduction for profits invested in land and depreciable assets. This deduction would be placed on a basis that took into account the depreciation of those assets, and a deduction would be added to recognize the need for working capital.

Conclusion

6.50 Taken together, the proposed changes in the taxation of international income add up to a significant change in tax policy. Canada would, in time, emerge with two international tax systems—a treaty system which would apply to income flowing to and from treaty countries, and a statutory system which would apply in non-treaty circumstances. By far the greatest portion of international income is expected to fall within the treaty system.

6.51 It is not, of course, possible to forecast the exact form that Canada's tax treaties would take. They would undoubtedly vary from one country to another, depending on the results of separate negotiations. Nevertheless, over recent years a fairly standard international tax treaty pattern has emerged. This pattern has to a considerable extent been codified in a draft model tax convention published in 1963 by the Fiscal Committee of the Organization for Economic Co-operation and Development. While few countries are prepared to accept all provisions of this draft treaty, it does generally represent the norm among the major developed countries. Canada's tax treaties will undoubtedly be influenced to a considerable extent by this draft treaty, but we too will require some modifications.

7

Co-ordination with the Provinces

7.1 A major concern of the government in the program of tax reform will be to maintain the high degree of co-ordination which has been achieved in recent decades between the federal and provincial income tax systems. Under Canada's constitution both the provincial legislatures and the Parliament of Canada have the power to levy income taxes. The provinces have the wide power of "Direct taxation within the province in order to the raising of a Revenue for Provincial purposes." Parliament has the broader power of "The raising of money by any mode or system of taxation."

7.2 It is the government's view that both jurisdictions should retain access to wide powers of taxation. Constitutional taxing powers should not be allocated between the provinces and Canada according to some prediction of fiscal requirements. Requirements change and are very difficult to predict. The actual use of the tax fields constitutionally available to both jurisdictions will depend upon the circumstances of the time, and ultimately on the judgments of the people and their representatives in Parliament and the legislatures.

7.3 However, the government has also recognized and stated that this broad approach to the division of taxing powers calls for harmonizing spending and taxing policies if the interests of the taxpayer are to be protected. Governments must consult on fiscal matters, and indeed they have consulted more frequently and extensively in recent decades. More discussion will be necessary, and is planned, to decide upon and to implement the proposals for tax reform set out in this paper.

Background

7.4 The existing pattern of inter-governmental occupancy and co-ordinating arrangements in one income tax field stems from extensive historical development. During the nineteenth century neither Parliament nor the provinces, other than British Columbia and Prince Edward Island, made use of the personal income tax. British Columbia was the only province to tax corporate income, although other provinces did impose certain types of levy on corporations. However, the chief users of income taxation were municipalities, exercising the powers given to them by the provinces to tax personal property. In the First World War the federal government first levied what would now be called an excess profits tax, and later, very reluctantly, introduced a general personal and corporate income tax as a war measure. This tax was continued after the war, gradually refined and extended, and increased during the depression of the 1930s. The provinces, meanwhile, had been slow to follow suit and it was not until the Depression forced them to seek new sources of revenue that more of them turned to income taxation. By the end of the 1930s almost all provinces and many municipalities had both personal and corporate income taxes.

7.5 The "tax jungle" that had quickly developed as a result of unco-ordinated policies was one of the subjects examined by the Royal Commission on Dominion-Provincial Relations. Its report in 1940 proposed that only the Dominion should have powers to levy income taxes and death duties, but that it should relieve the provinces of their outstanding debts and make large new annual grants to them. These far-reaching proposals encountered serious provincial opposition. Nothing came of them at the time except temporary war-time agreements by all provinces to "rent" the income tax and succession duties fields to Parliament for its exclusive use for the period 1941-46, subject of course to compensation.

Post-War Developments

7.6 Since 1946 there have been many federal-provincial discussions, conferences and arrangements relating to the co-ordinated use of these tax fields and to general fiscal compensation to the provinces. Until 1962 these arrangements usually took the form of "tax rental agreements" into which most provinces entered. Early in the post-war period the practice began of "abating" the federal taxes or allowing tax credits to enable the provinces to impose certain standard rates of corporation and personal income tax. In 1957 the subsidy element that had been implicit in the tax rental arrangements was separated out and distinguished as "equalization". This element has since been greatly broadened and increased. Abatements or tax credits increased several times between 1953 and 1967. Rates of provincial taxes have been increased to take advantage of these larger abatements and frequently to exceed them. As a result the relative provincial use of these fields has risen substantially. The abatement has risen from 5 per cent of the basic graduated personal income tax in 1953 to 28 per cent at present, and in six provinces the rates of provincial tax exceed this abatement level. In the corporation income tax field the provincial use has increased from about one-tenth of the total yield to nearly one quarter. (In succession duties it has increased from one-half to three-quarters). To help maintain co-ordination in tax policies, simplify the task of the taxpayer, and assist the provinces, the federal government has entered into agreements with most of the provinces under which it administers and collects provincial income taxes.

7.7 Over the long-term future it is possible that the provincial use of the personal income tax will come to equal the use made of it by Parliament. The largest single step in this direction took place in 1964 when Quebec accepted the general federal offer to pay most of the federal contribution to the hospital insurance and other health and welfare programs in the form of additional abatements of the federal income tax to allow for commensurately higher provincial rates. A subsequent similar offer to the provinces in 1966 has not been taken up, and is now regarded as having lapsed. A revised offer will be considered after reform of the income tax is implemented and the relative value of "tax points" and the costs of the major, continuing joint programs can be better appraised.

7.8 At present the general abatement of the basic federal income tax on individuals, to make room for provincial tax, is 28 per cent. Under the tax collection agreements the provinces define their tax, in effect, as a percentage of the applicable federal tax. The provinces of British Columbia, Ontario, Prince Edward Island and Nova Scotia have entered into collection agreements and use the same 28-per-cent figure to define their tax. Commencing January 1, 1970, the rate in Newfoundland, Saskatchewan and Alberta will be 33 per cent; in New Brunswick, it will be 38 per cent; and in Manitoba, 39 per cent. Quebec collects its own tax at graduated rates equal to 50 per cent of the federal graduated rates and with exemptions similar to those of the federal system, except for the absence of deductions for children eligible for family allowances and different starting points in basic personal exemptions. The Quebec tax rates are higher than those of the other provinces because of the higher federal abatement for provincial tax in that province (50 per cent instead of 28 per cent). In 1968 and 1969, Quebec tax liability is increased by the imposition of a temporary 6-per-cent surtax.

7.9 The abatement of the federal corporation tax to make room for provincial tax is 10 per cent of taxable income. All provinces except Ontario

and Quebec have entered collection agreements for this tax. Ontario and Quebec collect their own corporation income taxes but largely follow federal rules to determine taxable income and allocate it among the provinces. Commencing January 1, 1970, the provincial rates of corporation income tax will be: Newfoundland and Manitoba, 13 per cent; Ontario and Quebec, 12 per cent; Saskatchewan and Alberta, 11 per cent; and the other four provinces, 10 per cent.

7.10 This paper is concerned with the form and structure of the income tax rather than with its relative federal and provincial use. The question of relative use must be discussed from time to time in the light of changing circumstances, quite apart from any major readjustment related to sharing the costs of large joint expenditure programs. But it is evident that the provinces now make extensive use of income taxes, and parallel federal and provincial changes in the form of the tax are highly desirable. The government will therefore welcome extensive discussions of its proposals with provincial governments to reach a meeting of minds.

Collection Agreements

7.11 To assist the provinces in efficient and economical use of the income tax and to cause as little trouble to the taxpayer as possible, the federal government proposes to continue its offer to collect provincial taxes, without cost to the provinces. For personal income taxes this would be done, as at present, if the provincial tax were defined as a percentage of the federal tax, and therefore had the same rules for determining taxable income and the same level of exemptions. The provincial legislature would continue to determine the weight of the tax by specifying the percentage to apply to the federal tax. Under the proposals of this paper, there would be no need for a change in provincial rates in order to maintain the same revenues as at present. Changes in the provincial laws would be necessary to give credit to individual shareholders for the provincial share of corporation taxes in place of the present dividend tax credit which applies automatically to the provincial personal income taxes levied as a percentage of federal tax.

Abatements

7.12 As previously indicated, the government proposes that the present practice of abating the basic federal income tax to assist the provinces should be discontinued. Instead, the rate structure of the federal tax would be adjusted from the beginning to allow for provincial taxes. This change is proposed to simplify the law and make it easier for taxpayers to understand it and comply with it. It also reflects an intention stated in 1966 to give up the abatement system. By inference the general abatement appears to be or is interpreted as signifying the federal government's view as to the appropriate or proper rate of provincial tax. This imposes a practical barrier to the provincial government using a different rate, despite its legal freedom to do so. Moreover, it has diluted the provincial responsibility for determining and justifying its own tax rates. These are important objections in principle. The government believes that the abatement system has served its purpose over the past two decades as our new patterns of coordinated fiscal arrangements have developed. It is now accepted that the federal and provincial governments must take into account one another's use of the tax fields. Through analyses and discussion we seek continuously to reach some measure of common understanding and judgment on this most difficult issue in the working of the federal system.

7.13 The government is proposing a system to link personal and corporate income taxes. If this system is to work effectively, it requires that we deal with one combined level of federal and provincial income taxes across Canada. We believe it would be far too complex to reflect the different rates of corporate income tax in the various provinces. For this reason, we propose to continue the abatement system with respect to corporate income tax, and to construct the system of credits for corporate income tax on the basis of a national tax rate of 50 per cent.

7.14 An abatement of the federal income tax would also be required in order to continue the necessary adjustments with the Province of Quebec by which special reductions in federal taxes in that province would also continue to be made. These reductions are a partial payment for the federal share of the cost of certain joint programs such as hospital insurance and welfare assistance. It would be expected that Quebec would maintain its correspondingly higher provincial tax in order to secure the revenues it requires for these programs. The province would not, of course, need in any way to increase its existing rates in order to retain its present revenues. Abatements could also be used to provide corresponding treatment where other provincial governments take up a federal offer to meet all or part of the federal share of the costs of joint programs in this way. If all provinces entered into such arrangements, an adjustment of the basic rates could replace these abatements.

Tax Reports

7.15 In recent years, most of the provinces have had reviews made of their tax systems by special committees, consultants, or royal commissions. Many suggestions for reform have resulted. Only in Ontario and Quebec, which administer their own income tax law in whole or in part, did these reviews and recommendations deal at any length with the basic structure of the income tax. The Minister of Finance and his officials have reviewed these reports and recommendations and wish to record here their appreciation in particular of the work of the Smith Committee, the Ontario Legislative Committee, and the Bélanger Commission.

7.16 On a number of occasions provincial Ministers of Finance and Provincial Treasurers have given to the Minister of Finance and his officials the benefit of their views on some of the work and recommendations of the Royal Commission on Taxation, as well as on several of the general issues arising from that work. These representations have been appreciated and carefully studied. However, we have not felt free to put forward our thinking on these issues or others for their consideration nor have provincial representatives been asked to comment on specific questions of interest to us. With this paper we place our views before the provinces and we look forward to detailed discussions with provincial representatives on particular questions.

7.17 The government has taken particular note of the Ontario White Paper on the Reform of Taxation, accompanying the Ontario Budget of March 4, 1969. This official policy document has been useful in preparing this paper and we would like to comment on a number of its points.

7.18 The statement outlines the intention of the Ontario government to establish its own personal income tax system. As we understand it, the first objective of such a policy would be to gain a greater degree of independence in regard to the form and structure of the tax, including the rate of progression. We hope the general structure of the tax now proposed by the federal government commends itself to the Government and Legislature of Ontario. The second intent of the Ontario policy seems to be to get more provincial revenues from the personal income tax. This opportunity is freely available under the federal proposals; the provincial government and legislature would be free to increase the weight of the Ontario tax, as other provinces have done in past years. A third purpose of the Ontario proposal is described as making it possible to permit deductions from the provincial income tax by way of credits for property taxes, retail sales taxes and health insurance premiums. Such credits, it is said, might vary with incomes and family circumstances, and might even involve net payments to those whose credits exceed their provincial income tax liability. The introduction of such tax credits would greatly complicate the tax return and the collection administration. Nevertheless the government would be prepared to discuss the possibility of carrying out such operations under revised collection agreements. We suggest, therefore, that the achievement of Ontario's purposes may not require a separate income tax system.

7.19 The Ontario statement supports in principle the introduction of a capital gains tax. We hope Ontario will support the proposals for taxing capital gains set forth in this paper. Details of the

Ontario suggestions differ from federal proposals, but we are thinking along similar lines. The government believes that new solutions have been produced to deal with most of the problems that appear to have given rise to detailed suggestions in the Ontario statement. We also believe the proposals in this paper relating to the taxation of the mineral industry are consistent with the spirit and the measures which Ontario has set forth in its document. Further discussion on all these points is proposed.

Timing and Parallel Action

7.20 As for the implementation of proposals for income tax reform, the government suggests that the steps to be taken and arrangements to be effected with the provinces might be along the following lines.

7.21 After discussion of the present tax reform proposals in Parliament and with the provinces, revised proposals would be submitted for approval and enactment by Parliament in 1970, to come into effect in 1971.

7.22 The government would hope and expect that most provinces would decide to have Canada collect both their personal income taxes and their corporate income taxes on a basis consistent with the new federal law. They would continue to be free to set their own rates of corporation income tax, and their own rates of personal income tax in the form of percentages to apply to the new simplified federal tax. If provincial legislation is required, we would expect that time would permit such legislation to be enacted before the end of 1970.

7.23 If some provinces decide to collect their own income taxes, we hope they use rules for determining income, and a formula for allocating income among provinces, consistent with those in the new federal law. This would make compliance easier for taxpayers and avoid double taxation of the same income.

7.24 The government suggests that the provincial laws should provide for taxing the income of Canadian shareholders of Canadian companies on a basis consistent with the new federal law. Assuming that the proposals in this paper are adopted, this would mean using the system of corporate tax credits instead of the dividend tax credit already used by the provinces as well as by Canada. The provinces would tax the same amount as the federal law but give credit only for a standard 10-per-cent rate of provincial tax. With closely-held companies, a full credit would be given for an assumed provincial corporate tax of 10 per cent; with widely-held companies, credit would be given for an assumed provincial tax of 5 per cent. These credits would require appropriate changes in provincial legislation.

7.25 In Chapter 8 estimates are made of the effects on provincial revenues of the changes in the structure of the income tax proposed in this paper (see Table 14 page 94). While these estimates have been made as carefully as possible, it must be recognized that it is difficult to forecast accurately the effects on revenues of major changes in the structure of the tax, particularly where these have a somewhat differing impact upon the various individual provinces. The current formula for equalization payments to the provincial governments, if continued, would protect the position of those provinces with taxable capacity below the average of all provinces, up to the average. However, some risk remains for them all, and particularly for those with more than average taxable capacity.

7.26 The government does not wish to deter provincial authorities from adopting the changes in their income taxes that we are proposing in respect of federal taxes. We are therefore prepared to ask Parliament to provide some protection against this risk to provinces if they harmonize their tax changes with ours. More specifically, to any province which defines its personal income tax as a fraction of the federal tax and its corporate profits tax as a percentage of corporate income determined on the same basis as in the federal law, or to any other province that makes specified changes in its law to conform to changes in the federal law, we would propose to guarantee provincial revenue against unforeseen reductions in the aggregate yield of the revised personal and corporate income taxes for a period of several years.

8

Impact on Revenues and the Economy

Introduction

8.1 The objective of the tax reform proposals set forth in this paper is a redistribution of the income tax burden to better attain the goals and standards discussed in Chapter 1. The proposals have been designed to produce approximately the same revenue in the first year of their operation as would the existing income tax system. This design is illustrated in the following schedule, which sets out our estimate of the taxes that would be collected under each of the systems if they were applied in 1969. The figures are in millions of dollars and are the combined yield of federal and provincial taxes. Although the table shows a small increase in revenue, it is only of 1½ per cent which is for all practical purposes a balance given the hazards of forecasting.

	Present System	*Proposed System*	*Increase (Decrease)*
Personal income taxes	$ 7,720	$ 7,685	$ (35)
Corporation income taxes	3,075	3,285	210
Withholding taxes	210	200	(10)
	$ 11,005	$ 11,170	$ 165

8.2 The revenues of the provinces should also be approximately the same under the proposed system as under the present system. Estimates of the provincial revenues which would result from the two systems in 1969 are set out in Table 13 on page 94. These estimates indicate an over-all increase in provincial revenues of $20 million. They have been prepared on the basis that the provinces do not change the relative proportion of their personal income taxes to federal income taxes, or their rates of corporate income tax.

8.3 While the system has been designed to produce approximately the same taxes in the first year of its operation, we expect that it would yield increasing amounts of revenue over the next decade as the transitional measures are completed and changes such as the introduction of the tax on capital gains gradually take full effect. We estimate the system would produce 5 per cent more revenue in the fifth year than in the first. Because provincial rates of corporate income tax are already as high on small corporations as on large ones, the percentage increase in the yield of provincial taxes during the five years would not be as great as that for federal taxes.

Estimating Revenues

8.4 It is always hazardous to forecast revenues from income taxes. Part of the risk is in economic forecasting, which must cover not only total incomes but their broad distribution. Moreover, corporate profits are more difficult to forecast than other variables—because they depend on changes

in production, prices and costs, which can interact in an almost limitless number of ways—yet they are the basis of corporation income tax and affect capital gains substantially. These normal difficulties have been increased in recent years because substantial changes have been made in tax laws, particularly those relating to capital cost allowances.

8.5 The hazards of forecasting are increased when major changes are made in the tax structure. To estimate their effects it is necessary to know, to assume or to forecast on the basis of partial data, a number of factors that have not previously borne directly upon tax yields and are not reflected in tax statistics or other economic statistics. It is also necessary to forecast the reaction of taxpayers when confronted with new opportunities or new limitations on their behavior. These risks are particularly important in connection with the current program.

8.6 We believe that the forecast of total revenue on the basis of 1969 incomes, with all the changes proposed, is subject to only a modest error—at most a few per cent—and is not biased in one direction or the other. However, it must be recognized that an error of 1 per cent in a total of $10 billion is $100 million.

Personal Income Taxes

8.7 The basic instrument used in estimating the effects on personal income tax revenues of the changes proposed has been a large and carefully constructed sample of 100,000 personal income tax returns filed for the year 1967, the most recent year for which complete data is available. The sample is representative of the whole tax-paying population. It permits calculation of the revenue that would have been derived from all individual tax-payers in that year under different rules. Applying to the sample the actual rates for 1969, which is the base from which we are measuring the effects of changes, we derive a total revenue of $5,151 million. This total includes the basic tax before abatement of 28 per cent to allow room for the provincial tax and the additional abatement of 22 per cent in the case of Quebec. It takes into account the 1966 tax reduction, and the surtax in 1969. Finally, it includes the old age security tax and the social development tax. Thus the sample reflects the revenue yield of a uniform tax across Canada based on the federal law plus provincial taxes equivalent to the federal abatements. Using actual provincial taxes would add a little to the totals since most of the provincial rates are now higher than the abatements.

8.8 With this sample we can estimate the effects of changing rates, exemptions, deductions, etc. However, to calculate effects of entirely new items, additional data based on statistical knowledge, estimates or assumptions must be used.

8.9 To calculate the effects of taxing capital gains, the share gains and losses that would be taken into account have been estimated on the basis of a study made for the Royal Commission on Taxation of price behavior of Canadian stocks in relation to dividends. To this have been added figures for other gains and losses that might be expected on the basis of the relationships in the United States between gains on corporation shares and other gains. This latter estimate has been adjusted for differences between the U.S. tax structure and that proposed for Canada. These estimated gains have been distributed among the various income groups in the sample in order to calculate changes in tax yields. Estimates of this dispersion have been based on a detailed study of the United States figures which were published for 1962, taking into account such differences between the U.S. situation and the Canadian situation as appeared relevant, and the fact that 1962 was an unusual year in respect of capital gains and losses.

8.10 It has been necessary to estimate the proportion of the dividends received, and which would be received, by Canadian-resident individuals and by Canadian closely-held corporations, respectively, from closely-held Canadian corporations and from widely-held Canadian corporations. Assumptions have also been made about corporate behavior in the payment of dividends under the tax arrangements proposed for widely-held and closely-held Canadian corporations. It has been assumed that, once the system is fully effective, closely-held corporations effectively controlled in Canada would

pay out the whole of their profits in order that shareholders could take full advantage of the credit for corporate tax. Most of the additional payout is expected to be in the form of stock dividends. During the first four years there would be a tendency on the part of closely-held corporations controlled by high-income Canadians to delay this increased payout so that the marginal rates would have decreased as far as possible towards 50 per cent. All in all, we would expect only a modest increase in the total of cash and stock dividends paid by closely-held corporations in the first year of the new system, but a substantial increase in the fifth and subsequent years. We have assumed that widely-held corporations would not increase their dividends as a result of the tax proposals.

8.11 The steps described so far relate to the estimate of the yield of the two systems had they been in effect in 1967. To produce a comparison in 1969 terms, the amounts of wages, dividends, interest, and other income and deduction items on the returns in the sample were increased in accordance with the movement of these factors in the country since 1967. Different weighting was given to the returns in the sample to represent the more than 1,100,000 new taxpayers expected under the present system between 1967 and 1969. There are risks of error in projecting the results of the sample data in this way, but it is better to project systematically than to attempt to judge what the current, interrelated effects of the particular proposals would be on a rough and ready basis.

8.12 Several of the measures proposed would have an increasing effect as time goes on. The main instance of this is capital gains. The elimination from tax of any gains or losses arising before the valuation date would mean a gradual build-up of both taxable gains and losses. To reflect the gradual increase in revenues an estimate has therefore been made for the fifth year in which the new system is in effect. This estimate assumes the 1969 income base so that the difference reflects changes in the effectiveness of the tax system rather than economic changes. The fifth year marks the end of many of the transitional measures. The dual rate of corporation tax would be fully eliminated. The taxation of accrued capital gains on the shares of widely-held Canadian corporations would be in effect. The personal income tax rates would be fully adjusted to the new schedule. The revised international tax treaties should be in effect. Averaging would be fully in effect.

8.13 These estimates of the effect of the changes on revenue from the personal income tax are contained in Table 15 on page 95. The major changes in the exemptions, deductions and rates of tax applicable to personal incomes are interrelated. The effects on revenue of one depend upon whether or not the others are assumed to be in effect as well. The total effect is calculated by computer, taking into account all the changes and their interrelations. For purposes of exposition, however, and to give some idea of the scale of the effects of particular changes it is necessary to assume they are made in a particular sequence, in which the effect of each is appraised assuming the preceding ones have been implemented. These are then added up for total effect. All effects are evaluated on the basis of federal revenues plus hypothetical provincial taxes of 28 per cent of federal tax in provinces other than Quebec and 50 per cent in Quebec. The aggregate effects on provincial revenues are set out in paragraphs *8.32* to *8.34* below and in Table 14.

Personal Exemptions and Rates

8.14 Given the present rate structure as described above and present deductions and allowances, the increase in the exemption for single persons, and others taxed as single, to $1,400 from $1,000 and in the exemption for those taxed as married persons to $2,800 from $2,000 is estimated to cost $1 billion on 1969 incomes.

8.15 Given these increased exemptions but no other changes in the tax law, the change in the tax rates from the present complex of rates (including basic tax, old age security, social development, etc.) to the new simplified rate schedules proposed in Chapter 2 and set forth in Table 2, would increase aggregate revenues by $1,255 million on 1969 incomes. The effects of the subsequent reduction in top rates is noted below, in paragraph *8.19*.

8.16 With the new personal exemptions and rate structure in effect it is calculated that the cost of the proposed employment expense allowance of 3 per cent of income up to a maximum of $150 would be $235 million. This can be calculated accurately by the computer for 1967, and has been projected to 1969. On the other hand, it is much more difficult to estimate the cost of the next item, the child care allowance (see paragraph *2.7*). There is very little information on the expenses to be made eligible. Nor is it known to what extent mothers not now working would get jobs and take advantage of the proposal. It has been projected at an estimated cost of $95 million. The cost could turn out to be one-third more or less than this.

8.17 Taxing unemployment insurance benefits in 1969 would have increased tax revenues by about $85 million. Allowing the deduction of employee contributions would have reduced tax revenues by about $65 million. These estimates have been made on the basis of the current scales of benefits and contributions. A change in benefit and contribution levels could have a significant effect on these amounts.

8.18 A number of other smaller additions to revenue would arise from the inclusion of additional items in income and the reduction or elimination of some deductions. The total revenue forecast from the first group is $40 million and from the second group $60 million. The details of these changes and of the estimated revenue effects are set out in the footnotes to Table 15.

8.19 The reduction in the top rates of tax does not apply in the first year. It is estimated that by the fifth year when the transition would be complete, it would cost $40 million on the basis of 1969 incomes. This amount does not include what those extra rates would have produced on capital gains in the fifth year, because it is felt that the very high top rates would be incompatible with the tax treatment proposed for capital gains.

8.20 In the first year of the revised system, the inclusion of realized capital gains in income and the deduction of capital losses are estimated to produce net revenue of $60 million. This does not reflect an estimate of actual market behavior in 1969 but rather the longer-term relationship established in earlier years. It must be emphasized that this item cannot be forecast accurately, because it depends on changes in market values after the valuation date to be designated and on the behavior of Canadians confronted with a wholly new tax situation. If 1969 were the fifth year of the proposed system, the net tax revenue from realized gains and losses is estimated at $245 million. In addition, there is an amount of $100 million in respect of net gains arising through the periodic revaluation of the shares of widely-held Canadian corporations. In the fifth year, approximately one-fifth of the taxpayers who hold shares would follow this process.

8.21 The new averaging formula would not be in effect in the first year of the new system, and so would not affect revenue that year. By the fifth year it would be fully effective, at an estimated cost of $50 million.

8.22 The final item to be taken into account is the proposed change from the dividend tax credits to a new system for giving shareholders credit for part or all of the Canadian taxes paid by their corporations. Our expectations concerning the dividend policies of corporations were noted in paragraph *8.10*. On the basis of those expectations it is estimated that this change would have cost $140 million in personal tax revenue in 1969 if that had been the first year of the system and $230 million if it had been the fifth year of the system. The cost of this change must of course be considered together with the increased revenue expected from the removal of the low rate of corporation tax and from the taxation of dividends from widely-held Canadian corporations when received by closely-held corporations. Together these two corporate changes would have produced $155 million in tax revenue in 1969 if that had been the first year of the proposed system and $450 million if it had been the fifth.

8.23 The $140 million is the net of three amounts. First, the estimated credit to be given to shareholders would reduce revenues. Offsetting this there would be additional revenue from the tax collected on that credit, and on the increased dividends it is expected that the proposed system would

prompt. Finally the present 20-per-cent dividend tax credit would be cancelled: this would reduce the net cost of the proposed system. The following schedule illustrates the interaction of these three factors: the provincial figures are based upon a provincial tax at 28 per cent of federal tax. The figures are in millions of dollars:

	Combined Federal and Provincial	*Provincial Share*	
Tax on additional dividends and on the taxable credit itself	$ 210	(28/128)	$ 45.9
Dividend tax credit cancelled	130	(28/128)	28.4
	340		74.3
Credit for corporation tax	480	(1/5)	96.0
Net cost	$ 140		$ 21.7

Corporation Income Taxes

8.24 Less elaborate means have been used to forecast changes in the revenue from corporation income tax. These are based on total corporation profits as reported for statistical purposes and on the relation between profits and the corporate income tax in the past. Essentially, Dominion Bureau of Statistics figures on corporate profits have been projected to make estimates for 1969, with due allowance for using capital cost allowances in place of reported depreciation, and other differences now reflected in the latest profits statistics. We have also studied the effects on profits in corporations of various size of eliminating the dual rates of corporate tax. The estimates of the effect of the proposed changes on revenue from the corporation income tax are contained in Table 16 on page 96.

8.25 The main change, of course, is the gradual reduction over five years of the amount of corporate income subject to the 21-per-cent rate of tax. This would increase the yield of the federal corporation income tax by an estimated $95 million in 1969 if that were the first year of the new system and $390 million if it were the fifth year.

8.26 The proposed system contemplates that a tax will be paid when a dividend is received by a closely-held Canadian corporation from a widely-held corporation (paragraph *4.56*). This would, once the transition to the new system is complete, virtually eliminate the postponement of personal tax on this type of income. It is estimated that the extra corporation tax collected as a result of this provision would be of the order of $60 million annually, commencing in the first year.

8.27 Corporations, like individuals, would have taxable capital gains substantially larger than their capital losses. These are in addition to those business capital gains which have been taxable under the present law because they are part of the trading profits of the business, or represent the "recapture" of capital cost allowances previously claimed but recovered. The net revenue derived from these newly taxable gains is estimated at $35 million in the first year of the system and $100 million in the fifth.

8.28 Some modest loss of corporate tax revenue would arise from two sets of changes in taxing business income. The granting of capital cost allowances for "capital nothings", including goodwill, is estimated to cost about $5 million in each year. The broadening of the incentive offered for mineral exploration and development by permitting the write-off of such expenditures against other income by companies whose principal business is not mineral production or certain allied activities is estimated to cost $5 million in revenue in the first year, and $10 million in the fifth.

8.29 On the other hand the termination of depletion allowances on royalty income is estimated to increase revenue by $10 million in each year. The disallowance of deductions for the cost of club dues, conventions, entertainment, etc. is expected to save $5 million in revenue in both years. Finally, the new provisions to prevent diversion of income to tax-haven countries is expected to save about $10 million in both years.

Tax of 15 per cent on Accumulated Surplus

8.30 We expect that some corporations would take advantage of the extension of the present provision permitting tax-free distribution of accumulated surpluses on payment of a 15-per-cent tax (paragraph *4.78*). However, the amounts are almost impossible to predict and could vary substantially from year to year depending upon how many and which corporations are wound up or reorganized that year, or choose to make a partial distribution of this type.

Withholding Taxes

8.31 The estimated revenue effects of changes in the withholding taxes are set out in Table 17 on page 96. We might expect in the first year to gain about $5 million from the withholding tax on pensions and payments to non-residents from Canadian pension funds and registered retirement savings plans. In the fifth year after the revision of the tax treaties we would expect this figure to be substantially higher, perhaps of the order of $10 million. We would also expect in the fifth year an increase in revenue from higher withholding taxes from payments made to those countries with whom we do not have tax treaties. This is estimated at roughly $5 million. On the other hand, we must expect to lose about $15 million a year on the flow-through arrangement in respect of credit for foreign withholding tax.

Provincial Revenues

8.32 An estimate of the effect of the proposed changes on a province's revenues must take into account, in addition to increased or decreased tax revenues, the effect of those increases and decreases on the equalization payments to be made to the province by the federal government under the Federal-Provincial Fiscal Arrangements Act. The formula for determining the amount of equalization payments is necessarily complex, but it might be summarized as follows. If the total tax base in a province—the things the province can tax—is below the national average on a per capita basis, the federal government pays to the province an amount equal to the additional tax revenues the province could collect at national average rates of tax if it had an average tax base.

8.33 In 1969, seven provinces—all but Ontario, Alberta, and British Columbia—are receiving equalization payments. The result is that these seven provinces would lose revenue as a result of tax reform only if the total provincial tax revenue decreased. If the yield of a tax in one of these provinces decreased but total provincial revenues from that tax increased, increased equalization payments would more than fill the hole in the province's revenue. Ontario, Alberta and British Columbia are in the position that a change in provincial revenues is not offset by a change in equalization payments.

8.34 Table 13 on page 94 indicates that all provinces will receive slightly more in revenue if the proposals in this paper are implemented. The total provincial revenues from personal income tax would be down less than 1 per cent but this decrease would be more than offset by the increase in corporation taxes. At the same time, the three provinces that are not protected against individual reductions in tax yields all would have increases.

Economic Effects

8.35 The tax reform proposals set forth in this paper are expected to have relatively modest impacts upon the Canadian economy apart from the effects on savings in closely-held companies, and possibly on investment in the mining industry. Our general conclusions are outlined below.

8.36 One economic issue is the influence of the proposed tax changes on the effort men and women put into their work. Will they work as much of the year, or work as hard, if taxes change? Here there is little firm quantitative evidence on which to base a conclusion. But there are many individual observations, opinions and experience, and some fairly evident arguments. The higher a man's income, the less he needs additional income and therefore the less he needs to work harder. On the other hand he is likely to be a person who will work

hard anyway. The higher the total tax a man pays, the more he needs to work or to get a better job to support himself and his family and to attain his other material objectives. But the higher the tax he must pay on anything extra he earns—his marginal rate of tax—the less inducement there is to work longer or harder to earn more. The royal commission considered this subject at length and concluded: "We are persuaded that high marginal rates of tax have an adverse effect on the decision to work rather than enjoy leisure, on the decision to save rather than consume, and on the decision to hold assets that provide monetary returns rather than assets that provide benefits in kind. We think there would be great merit in adopting a top marginal rate no greater than 50 per cent." The government agrees with this conclusion. It shares the belief that such a limitation on the top rate, which would come in gradually, would increase the willingness of those who earn high incomes, such as doctors, other professional men and business executives, to choose additional work at the margin rather than additional leisure.

8.37 The proposals in this paper involve some increases in marginal rates up to incomes of $15,000 or $17,000. These increases may have some modest effect on the incentive to work overtime or more intensively or to seek advancement by extra effort or training. On the whole, however, the increases do not seem large enough to change behavior patterns in any marked degree.

8.38 A second issue is to what extent Canadian income taxes affect the ability of Canada to retain able and highly trained Canadians who could emigrate to the U.S., and to attract skilled and able persons from the U.S. or elsewhere. When the royal commission considered this matter it concluded: "We are skeptical that tax factors have been a major factor in emigration." Since then changes in conditions in the U.S. seem to have made that country less attractive to Canadians considering emigration and changes in its immigration laws have made it more difficult for Canadians to emigrate to the U.S.

8.39 The Canadian income taxes proposed in this paper, plus the Canada (or Quebec) Pension Plan contributions, would normally be less than the current U.S. income taxes plus their social security contribution, for single persons at all income levels. They would also be less for most married persons; for example, those with two children and earning $8,000 or less. At higher income levels married persons would pay somewhat more in Canada, depending on their incomes and circumstances. The differences are not large until incomes exceed, say, $20,000, and above that the gradual reduction of the top rates to about 50 per cent would limit the gap. We believe that these differences for married persons with higher incomes could best be met in the market by adjusting the pay scales for those individuals or scarce categories who must be retained or attracted against U.S. competition.

8.40 Some impact on the flow of savings is inevitable in a tax reform that includes capital gains in taxable income, shifts the weight of the tax from those at the lower income levels to those better able to pay and ensures that the income of closely-held corporations is taxed at rates appropriate to their shareholders. Practically all of the increase in corporation tax revenue estimated in Table 16 would result in a reduction of corporate savings. We do not anticipate much of the increased taxes would be passed on to customers in the next few years or made up by reductions in dividends. Over a longer period some such adjustments are more likely, perhaps in the form of delayed increases in dividends from widely-held corporations, or from others controlled by non-residents. In the case of closely-held corporations it would be very much in the interest of their taxable Canadian shareholders to pass through to their shareholders the creditable corporate tax by paying dividends, and not let it become "staledated". Consequently we would expect an increase in their dividends after the first year or two, although this would largely take the form of stock dividends in cases where the funds are needed in the corporation for business purposes. The Canadian shareholders receiving such dividends would get a substantial credit for the increase in corporate tax paid, as indicated in the totals for the first year in paragraph *8.23*. We expect that a large part of the net after-tax increase in the amount of this credit over the present dividend credit would be saved, offsetting the reduction in saving by the corporations concerned.

8.41 The impact of the various proposed changes in personal exemptions, individual tax rates, inclusion of capital gains, etc., apart from the items implementing the integration of the corporate and personal tax, would reduce personal savings modestly. We estimate the amount might be about $30 million in the first year and $75 million in the fifth. Adding these to the estimated reductions in corporate saving and the offsetting increases in saving out of the credit for corporate tax by shareholders we obtain a total reduction of saving of about $150 million in the first year of the new system and about $525 million in the fifth year, both based on estimated 1969 income levels. These changes may be compared with an estimated total of personal and corporate saving and capital cost allowances of about $14 billion in 1969.

8.42 The combination of the personal and corporate tax changes proposed would affect the after-tax return obtained by individual Canadian investors in various types of securities. A detailed exposition would be very lengthy, and we do not intend to predict market reactions to the changes. However, several general points are to be noted.

8.43 There should be no change in the after-tax return to an individual from buying a bond or mortgage at par. Those bought at a discount would have their after-tax yield to maturity affected by the tax on the realized gain, subject to the limits and safeguards noted in paragraph *3.29*. Many large holders and buyers of bonds are now free of tax, like pension funds, and would continue to be free of tax, or they already pay tax on the capital gain element. The after-tax yield to them of buying bonds should not be affected.

8.44 The effects on the after-tax returns on investments in the shares of widely-held Canadian corporations are much more complicated. The credit for half of corporate tax must be taken into account as well as the tax on half the capital gain when realized or when accrued at the five-year dates proposed. For high-income shareholders with marginal rates of 50 per cent (or more at the beginning) the expected after-tax return would be lower, the amount of the decline depending on the proportions of the gross return expected in the form of dividends and in the form of capital gains. For shareholders with low marginal tax rates the after-tax return would increase, unless a high proportion of the expected return is capital gain. For tax-free registered pension plans and retirement savings plans there would be no tax, no tax credit and no change in after-tax return—so they might be expected to be a stabilizing force in the market.

8.45 The expected after-tax return on investments by Canadian residents in foreign shares would decline substantially more than the return on comparable shares of widely-held Canadian corporations. The capital gains realized on foreign shares would be taxable in full (and capital losses deductible in full) and there would be no credit for corporate tax paid, but only for the foreign withholding tax. As a consequence we would expect a substantial diversion of Canadian investment from foreign shares to Canadian securities compared with recent years.

8.46 For special reasons there are a few types of investment where the after-tax return on investment would be affected in still other ways. Some companies for one reason or another distribute more in dividends than they pay in corporate income tax. If this continued they would not be able to provide the full amount of creditable tax with dividends. The proposed termination of shareholders' depletion on dividends paid by companies in the mineral industry would of course reduce the immediate return on an investment in their shares, but if such dividends in fact reflect a return of capital the new provisions regarding the deduction of capital losses would be available. Implementation of the proposals for the corporate taxation of companies in the mineral industries would presumably be reflected after some years in the after-tax rate of return of those companies and their shareholders, particularly if the company does not carry on enough exploration or development work to earn a depletion allowance on its producing properties. The after-tax return of investment in the ownership of buildings for rent, particularly by those intending to write off book losses on rentals against other income, would be reduced; this is a consequence of closing what has become a serious loophole in the present tax law.

8.47 Non-resident investors in Canada should not be substantially affected by the tax changes proposed in this paper except in particular categories. Withholding taxes on interest received by residents of countries with whom Canada now has tax treaties can be expected to remain the same, certainly on obligations issued before 1974 and probably by treaty on later issues. Withholding taxes on dividends would remain the same until 1974 and for residents of countries with which we have tax treaties they would probably continue at 15 per cent. However, one must expect higher rates to apply to interest, dividends and royalties paid to residents of tax-haven countries, subject to the qualifications noted in Chapter 6, and consequently the rate of return on Canadian investments made from or through such countries would decline. The general provisions affecting corporate income tax would affect the after-tax corporate income available for dividends to non-resident investors. Non-resident investors in the mineral industries would be affected after some years by the elimination of the three-year exemption for new mines and by the need for corporations to "earn" their depletion allowances. Non-resident investors would also be subject to capital gains taxes on the disposition of certain types of assets in Canada, notably real property, partnership interests, branch assets of business operations, the shares of closely-held Canadian corporations, and shares out of blocks larger than 25 per cent of widely-held Canadian corporations. On the whole these changes affecting non-residents are not expected to cause any substantial reduction in foreign investment in Canada, although some decline must be expected in foreign investment in the mineral industries and in small closely-held corporations.

8.48 The changes proposed in the special tax rules applying to the mineral industry would have some effect in reducing the expected rate of return both from new mining projects and new oil and gas projects. The amount of the reduction would depend on the nature of the project and whether the owners expect to earn depletion to deduct from the income from the project. The over-all effect on the development of new mines cannot be forecast with any certainty; it would probably depend on general attitudes as well as on calculations. We do not expect it to be serious, though no doubt there would be some marginal projects abandoned or deferred in the next several years. The extra inducement offered in the mineral industry through the "earned depletion" and the immediate write-off of capital costs of new mines should continue to attract capital from Canadian sources and abroad, in competition with the resources and investment conditions offered in other countries. In addition, the ability to deduct exploration and development costs from other income, even for taxpayers not in the mineral or related industries, should help sustain the scale of exploration activities for mining deposits and oil and gas. All in all, the mineral industries would continue to be stimulated by some tax measures not offered to other industries, but not to as great a degree as under the present law.

8.49 The general economic effects of these proposed tax changes would include some moderate reduction in aggregate private saving and probably some reduction in the capital expenditures of closely-held corporations and the mineral industries. These would be offset by a small immediate increase in public revenues, and a rather larger increase after the early transitional years. These aggregate changes, however, could be taken into account in the determination of monetary and fiscal policy and could be offset in their general effects on total incomes, employment and prices. The most significant factor in the long term would be the moderate reduction in the rate of corporate saving by closely-held corporations; this may be offset by other trends, such as greater saving through pension funds and mutual funds.

8.50 The balance of international payments of Canada would be affected by a number of the proposed changes, but on the whole it should be modestly improved. There is no reason to expect any significant early effect on the current account of the balance of payments, including the net flows of interest and dividends. As noted in paragraph *8.47*, foreign investors except in some special circumstances should not suffer any significant reduction in after-tax rates of return. The special circumstances applying to investments in the mineral industry and closely-held corporations might lead to some reduction in the flow of direct investment

TABLE 13

Provincial Revenues from Income Taxes and Related Equalization Payments Present System and First Year of Proposed System on the Basis of 1969 Incomes

	Present System	*Proposed System*	*Increase*
		($ millions)	
Newfoundland	65.2	65.5	.3
Prince Edward Island	13.0	13.1	.1
Nova Scotia	88.7	89.1	.4
New Brunswick	81.5	82.1	.6
Quebec	747.8	752.4	4.6
Ontario	1,100.7	1,106.6	5.9
Manitoba	145.2	146.9	1.7
Saskatchewan	122.7	123.4	.7
Alberta	204.3	207.6	3.3
British Columbia	267.2	270.0	2.8
TOTAL	2,836.3	2,856.7	20.4

Notes:

(a) Further information concerning the increase is set out in Table 14

(b) The rates used in this table and in Table 14 are as follows:

	Personal Income Tax	Corporation Income Tax
Nfld.	33%	13%
P.E.I.	28	10
N.S.	28	10
N.B.	38	10
Que.	31	12
Ont.	28	12
Man.	39	13
Sask.	33	11
Alta.	33	11
B.C.	28	10

Except for the personal income tax rate of 31 per cent in Quebec, the rates above are those in the provincial statutes for 1970. Because Quebec's personal income tax rates and rules differ from those of other provinces and the federal government, the yield in Quebec is only approximate: the 31-per-cent rate is the difference between 53 per cent, the approximate weight of the Quebec tax, and the 22 percentage points that relate to the cost of particular programs where final payments take these points into account.

TABLE 14

Provincial Revenue Effects of Proposed Tax Changes in the First Year on the Basis of 1969 Incomes

	Increases or (Decreases) Related to Personal Income Tax Changes		*Increases or (Decreases) Related to Corporation Income Tax Changes*		*Net Increase*
	Tax Revenues	*Equalization Payments*	*Tax Revenues*	*Equalization Payments*	
			($ thousands)		
Newfoundland	(712)	369	349	314	320
Prince Edward Island	(190)	125	43	84	62
Nova Scotia	(1,296)	812	413	452	381
New Brunswick	(684)	561	326	385	588
Quebec	(6,508)	3,672	6,412	1,081	4,657
Ontario	(5,737)	—	11,616	—	5,879
Manitoba	658	(276)	1,189	129	1,700
Saskatchewan	(30)	(427)	749	381	673
Alberta	1,303	—	2,016	—	3,319
British Columbia	326	—	2,498	—	2,824
TOTAL	(12,870)	4,836	25,611	2,826	20,403

For the rates of tax used in this table, see note (b) to Table 13.

in them. The changes affecting the after-tax rates of return to Canadian investors in widely-held Canadian corporations do not appear likely to lead to a widespread buying out of the holdings of non-residents resulting in a large withdrawal of capital. On the other hand, we expect a substantial reduction in the net outflow of funds from Canada to purchase the shares of foreign corporations. The limits on the foreign investments of registered pension funds and retirement savings plans would safeguard against any major outflow through those tax-free channels. The tax changes should cause little if any change in the after-tax rate of return of non-resident investments in Canadian bonds or mortgages or of Canadian investments in foreign bonds or mortgages. We do not expect that they would lead to any major change in the international flows of capital into interest-bearing securities. In total, therefore, we expect the result of these tax changes to be a modest reduction of the inflow of foreign equity capital into Canada and a somewhat larger reduction of the outflow of Canadian equity capital. The net effect on the balance of payments should be well within the range with which the normal offsetting and adjusting mechanisms can deal.

TABLE 15

Revenue Effects of Personal Income Tax Changes on the Basis of 1969 Incomes

	First Year	*Fifth Year*
	($ millions)	
1. Increased basic exemptions. This includes revenue effect of changes in amount deductible where spouse or dependant has income	− 1,000	− 1,000
2. Rate schedule changes	+ 1,255	+ 1,255
3. Employment expense allowance, moving expenses and other deductions for expenses	− 235	− 235
4. Child care allowance	− 95	− 95
5. Inclusion in income of unemployment insurance benefits	+ 85	+ 85
6. Deduction of unemployment insurance premiums paid by employees	− 65	− 65
7. Other items included in income (see note (c) for details)	+ 40	+ 40
8. Expense deductions either cancelled or reduced (see note (d) for details)	+ 60	+ 60
9. Full reduction of top rates in rate schedule	0	− 40
10. Inclusion in income of capital gains and deduction of capital losses	+ 60	+ 245
11. Deemed realization of gains on widely-held company shares	0	+ 100
12. Averaging	0	− 50
Sub-total	+ 105	+ 300
13. Effect of integrating personal and corporate income tax	− 140	− 230
TOTAL	− 35	+ 70

Notes:

(a) In calculating the effect of each revenue change, it is assumed that the preceding change has been put into effect, for example, the effect of the rate schedule changes is computed using the increased basic exemptions.

(b) The amounts shown for personal income tax revenue changes are federal revenue plus provincial revenue from a provincial tax at 28 per cent.

(c) The other items included in income are:

Adult occupational training allowances	$15 million
Armed forces changes	10
Personal use of business cars, etc.	5
Additional interest paid by co-ops, credit unions and caisse populaires	5
Fellowships, scholarships, bursaries and grants	5
	$40 million

(d) The expense deductions cancelled or reduced are:

Depreciation on rented buildings	$27 million
Cancellation of depletion allowances for non-operators	15
Cancellation of deduction for club dues, entertainment, conventions	12
Change in definition of deductible medical expenses	6
	$60 million

TABLE 16

Revenue Effect of Corporation Income Tax Changes
on the Basis of 1969 Incomes

	First Year	Fifth Year
	($ millions)	
1. Reducing the amount subject to the low rate of corporate income tax	+ 95	+ 390
2. Collecting a tax on dividends received by closely-held corporations from widely-held corporations	+ 60	+ 60
3. Inclusion in income of capital gains and deduction of capital losses	+ 35	+ 100
4. New deduction for "nothings"	− 5	− 5
5. New rules for deducting exploration and development expenditures by companies whose principal business is not mining, petroleum, or gas	− 5	− 10
6. Cancellation of deduction for depletion allowance allowed to non-operators	+ 10	+ 10
7. Cancellation of deduction for club dues, entertainment expenses, conventions, etc.	+ 5	+ 5
8. Provisions directed specifically against tax-haven abuses	+ 10	+ 10
TOTAL	+ 205	+ 560

Notes:

(a) In calculating the effect of each revenue change, it is assumed that the preceding change has been put into effect.

(b) The amounts shown for corporation income tax changes are federal revenue plus provincial revenue from a provincial tax of 10 per cent.

TABLE 17

Revenue Effect of Withholding Tax Changes
on the Basis of 1969 Incomes

	First Year	Fifth Year
	($ millions)	
1. Foreign dividend withholding tax "flow-through" mechanism	− 15	− 15
2. Extension of non-resident tax to pension and registered retirement savings plan payments	+ 5	+ 10*
3. Higher withholding taxes on investment income going to residents in non-treaty countries	—	+ 5
TOTAL	− 10	0

*In the expectation that tax treaties will have been revised so as to permit this deduction.